Institutional mandates face years of outflow

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Large super funds are increasingly internalising asset management functions in a bid to cut costs. With industry consolidation quickening, most super assets will soon be managed by funds with mature internal management capabilities – this has serious ramifications for institutional managers.

Institutional managers to haemorrhage FUM for a decade as the Super industry goes DIY on asset management

Super fund consolidation progressed at an agonisingly slow rate for years, but whether driven by economic, regulatory, or other agendas it is now progressing at pace.

Consolidation is leading to a growing pool of large funds with scale economies that allow them to re-think their operating models, and with particular focus on managing their asset management expenses many more are beginning to internalise asset management functions.

Growth in internalisation is not a new phenomenon but it is being accelerated through consolidation in the industry, and – importantly – this comes at the expense of institutional mandates.

For institutional asset managers, this raises two questions; (1) where will this rotation to internalised management end; and (2) what can they do to respond?

Where will it end?

We know that funds typically start to internalise asset management functions as they approach $50b in FUM.

Giant funds (>$50bn) currently account for about 75% of all non-SMSF super assets – and we expect this to reach over 90% in the next decade. About three-quarters of these ‘giants’ are currently internalising asset management, and we expect greater take up as funds become more comfortable with the model.

We also know that the funds that are currently internalising have stated medium to long-term targets of around 50% of their public market assets being managed by internal teams. We see no reason for these targets not to become industry standard, and some funds will go further.

The result of all this is that we expect to see up to 40% of all super fund assets being managed internally in the medium term (the market is currently at about 15%).

We have observed that once funds have a tested internal capability, they are quick to utilise and grow it at scale, with the flow to internal capabilities outpacing fund inflows i.e., external mandates are rotated into internal capability.

> *40% of all Superannuation assets to be internally managed by 2032*

Exhibit 1: Internal rotation is only just getting started

Source: NMG Super Funds Review, NMG estimates

Implications for institutional asset managers

While flows to super funds will remain strong, market consolidation will see the rotation to internalised assets accelerate, leading to rapidly declining (and eventually negative) flows to institutional asset managers as the market searches for a new equilibrium.

> *Mandates will face years of outflow as the industry rebalances*

Exhibit 2: Mandates face sustained net outflow

Source: NMG Super Funds Review, NMG estimates

How should institutional managers respond?

First things first, while there is growing adoption of internalisation, institutional asset management is not dead.

> *Managers with clearly differentiated offerings are going to be best placed here*

In a recent NMG study, MySuper CIOs indicated that what they are looking for, among other things, is:

- Managers who can shift between high conviction and low tracking error portfolios (to help manage performance against YSYF performance tests);
- High conviction managers in sub-asset classes; and
- Exposures where manager skill is highly important and execution capabilities are non-replicable (private markets, alternatives, infrastructure, unlisted property, etc.)

Managers without these specialist capabilities need to work out how they build or acquire them – quickly. Those who can't will find themselves passive participants in this shift.

By [Lachlan Reardon]