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Intermediated investment management in private markets: Evidence from pension fund investments in real estate ☆

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A B S T R A C T

We evaluate the economics of financial intermediation in alternative assets by investigating the allocation and performance of pension fund investments in real estate, the most significant alternative asset class for institutional investors. We document substantial heterogeneity in real estate investment cost and performance, determined by two main factors: mandate size and investment approach. Larger pension funds are more likely to invest in real estate internally, have lower costs, and higher net returns. Smaller pension funds invest primarily in direct real estate through external managers and fund-of-funds, and disregard listed property companies. Overall, we find that delegating real estate investment management to financial intermediaries increases costs and disproportionally reduces returns.

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1. Introduction

Over the last decade, institutional investors have significantly increased their exposure to alternative assets. For instance, pension funds increased their exposure to real estate, private equity, hedge funds, infrastructure, and commodities from 9% in 1990 to 16% in 2010 (Andonov, Bauer, and Cremers, 2012), while university endowment funds increased the allocation to alternative assets from 7% in 1989 to 19% in 2005 (Brown, Garlappi, and Tiu, 2010). The markets for these private assets are generally less transparent than public markets, and institutional investors face significant fixed costs related to learning, understanding, and monitoring the investments.

To achieve superior returns in private markets, gathering information about specific assets and capitalizing on the acquired informational advantage requires a high level of specialization. This induces the majority of institutional investors to select external investment managers who are specialized in a single asset class, and to delegate portfolio decisions to these specialists (Blake, Rossi, Timmermann, Tonks, and Wermers, 2013). However, delegated investment management can cause misalignment of objectives between institutional investors and their external managers, including loss of diversification, unobservable managerial appetite for risk, and different investment horizons (Sharpe, 1981; Binsbergen, Brandt, and Koijen, 2008).

Institutional investors can prevent these agency conflicts by employing well-qualified specialized asset managers to work in their internal investment divisions, but they face high costs to attract human capital and to collect market information. Indeed, over time pension funds have increased their allocation to external managers and fund-of-funds at the expense of in-house asset managers. Investor movement towards delegated portfolio managers in the private market is rational, if financial intermediaries are able to deliver higher returns than internal managers. However, hiring external investment managers does not necessarily ensure better performance (Brown, Goetzmann, and Liang, 2004; Chen, Hong, Jiang, and Kubik, 2013), which may be due to coordination problems and, importantly, higher fees. Indeed, it has been argued that the increased prevalence of delegated asset management is simply due to pension funds shifting responsibility for potentially poor performance to external managers and fund-of-funds (Lakonishok, Shleifer, and Vishny, 1992).

This paper contributes to the literature on financial intermediation and investment performance, as well as to the literature on alternative assets. We focus on the allocation and performance of pension funds in real estate investments, which is the most significant alternative asset class for institutional investors.[1] Real estate offers unique possibilities to explore the role of intermediated investment management.

First, real estate is the alternative asset class with most heterogeneity in the implemented investment approach. On the one hand, internal management (i.e., direct selection of properties or REITs, without intermediaries) accounts for a significant part of pension fund assets. On the other hand, in addition to delegating investments to external managers, pension funds increasingly use fund-of-funds, which yields an additional layer of intermediation. Internal management is also possible in private equity, but this approach is significantly less common,[2] whereas for investments in hedge funds, internal management is almost impossible and the choice of investment approach is limited to external managers or fund-of-funds. The heterogeneity in investment approach allows us to assess its importance for performance outcomes, which has hardly been addressed in the private equity literature. Fang, Ivashina, and Lerner (2013) study the internal investments made by seven large pension funds, but otherwise, the private equity literature is focused solely on delegated investment management. For real estate, many pension funds have deep and broad experience in internal management, so we can make a viable comparison between investment approaches for a significant number of pension funds.

[1] For example, all properties in the most widely used U.S. private real estate index, the NCREIF Property Index (representing more than $315 billion in 2012), have been acquired, at least in part, on behalf of tax-exempt institutional investors – the great majority of which are pension funds. Outside of the U.S., pension funds constitute more than 60% of the investors in the IPD U.K. property database (Bond and Mitchell, 2010), the main U.K. private real estate index.

[2] According to the CEM database, on average, only 11% of the private equity investments are managed internally, while in real estate the internal investment approach accounts for 19% of the assets (http://www.cembenchmarking.com/Default.aspx).