PGIM

IAS EXECUTIVE SUMMARY

THE SCALE EFFECT

How Size Shapes Investment Governance and Allocation

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Recent years have witnessed a trend in pension plans towards larger size, as large institutions continue to gather assets and as smaller investors group together to emulate their larger peers' perceived successes. Greater scale permits a fund to build in-house expertise, to rely less on external advisers and portfolio managers, build internal capabilities across portfolio design and management, and incorporate more complex transactions into their investment process. Smaller funds in contrast find sufficient investment opportunities in public markets and can leverage tried and tested asset allocation approaches, where external assistance is readily available.

Dimensions of The Scale Effect

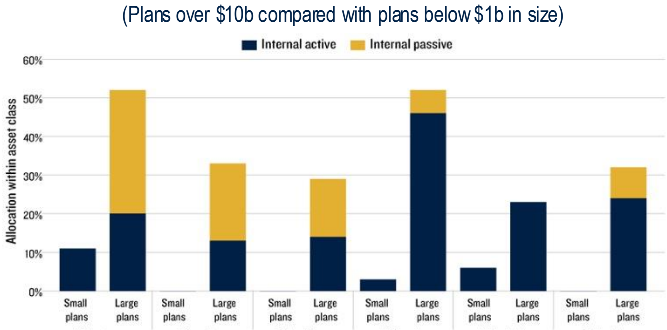
Avoid Diseconomies of Scale ← → Gain from Economies of Scale

	Smaller funds (< $1b)	Larger funds (> $10b)
Invest	Use off-the-shelf allocation process	Tailor asset allocation approach
Invest	Third parties have ample capacity	Develop internal management
Invest	Advisers can help source managers	Access to private market managers
Invest	Staff cost and better retention	Better attract expertise
Govern	Board retains control of strategy	CIO actively drives strategy
Govern	Limited co-ordination problems	Efficiency gains from role division

Source:. PGIM IAS. For illustrative purposes only

Economies of scale are powerful for driving down costs, through greater bargaining power with third parties and moving management in-house where this would be more efficient. But scale can also raise costs: market liquidity makes trading large portfolios expensive, and finding sufficient return opportunities for a large asset pool can be much more challenging than for a smaller one. To help overcome these "diseconomies of scale" larger plans allocate more into more complex asset classes such as private equity and infrastructure. Here return is often generated less by active trading, but management costs are often inherently higher.

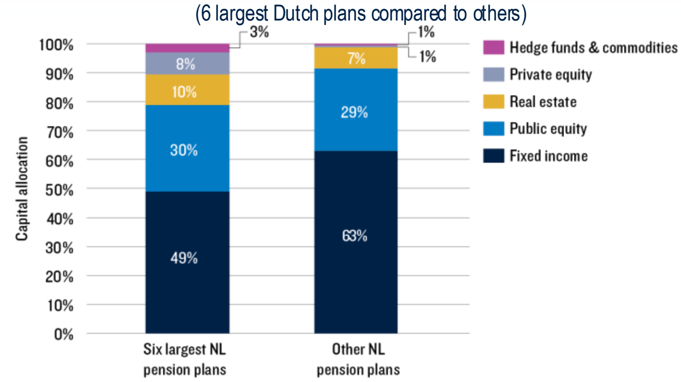
Larger Plans are Bigger Users of Internal Managers and of Passive Styles
(Plans over $10b compared with plans below $1b in size)



Source:. CEM Benchmarking, de Vries et al (2023), PGIM IAS calculations.

Responsibility for owning and driving the investment policy gravitates from the Board to the CIO as fund scale increases. Greater resources allow division of responsibilities that bring efficiency gains but can easily lead to silo behaviour and create co-ordination problems for a CIO. Governance structures therefore play a critical role.

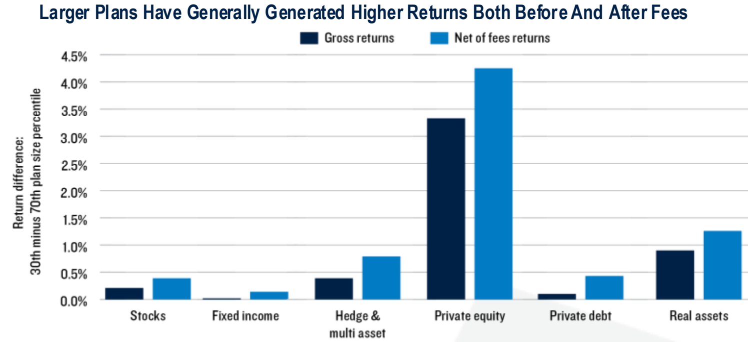
Larger Plans Invest More into More Complex Asset Classes
(6 largest Dutch plans compared to others)



Source: Bikker & Meringa (2021), PGIM IAS calculations.

Policymakers and regulators often drive consolidation, keen to boost policyholder outcomes but also to create local mega-funds capable of helping to fund the domestic economy. The drive to pool resources needs to be framed in terms of better outcomes – a narrow focus on costs would prevent plans in their pursuit of returns as they grasp new opportunities. Larger plans have delivered greater returns both before and after costs, but not by keeping their allocations fixed.

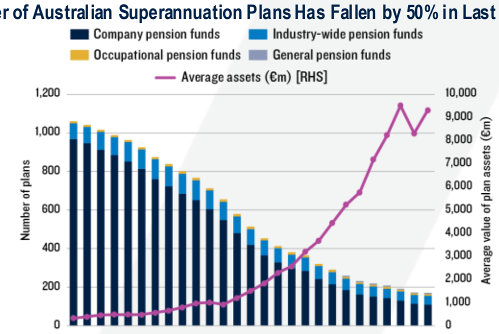
Larger Plans Have Generally Generated Higher Returns Both Before And After Fees



Source:. CEM Benchmarking, de Vries et al (2023), PGIM IAS calculations.

Australia's superannuation funds perhaps show a path. The regulator APRA publishes a net-of-fee active return metric that has helped to drive consolidation within the industry, creating a small number of large players.

Number of Australian Superannuation Plans Has Fallen by 50% in Last Decade



Source:. APRA (2023), PGIM IAS calculations.

The funds that have closed or merged did not allocate as much to infrastructure or private equity as their peers. The larger Supers generally allocate more here than smaller funds and produce higher returns.

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