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Outsourced CIO - What Does It Mean to You?

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Today's Reality

The demands upon institutional investors – endowment & foundation investment committees, pension sponsors, and the fiduciaries charged with overseeing those asset pools – are greater now, arguably, than ever before. Board members, investment committees, and senior executives find themselves executing investment decisions against the backdrop of a uniquely challenging environment. Today's headwinds include:

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- Heightened market volatility
- Lower projected capital market returns
- Higher projected outflows against the asset pool (e.g., operating expenses and pension liabilities)
- Historically low interest rates

Today's Solutions

Following a trend that began to accelerate on the heels of the 2008-09 financial crisis, demand for discretionary/outsourced chief investment officer ("OCIO") services continues to gain momentum among institutional investors. Various surveys[1] indicate exponential growth in both the interest exhibited in and the outright deployment of outsourcing solutions. This acceleration of interest can be attributed to a number of factors, including:

- A lack of internal resources and expertise at the investment committee and staff levels
- Committee and governance structures that generally do not lend themselves to a timely response to changing capital market conditions
- A seemingly never ending array of new investment strategies
- Frustration with the recent results generated by previously selected active managers

Apples and Oranges

Organizations that choose to investigate an outsourcing framework, however, are confronted by a relatively immature marketplace that renders these services in a wide variety of manners. Traditional investment consulting firms, large scale asset management complexes, specialty firms, and variants thereof have entered the fray. Estimates suggest that there are somewhere on the order of eighty firms offering up some permutation of outsourcing. Approaches run the gamut from "delegated consulting," in which the client may retain some degree of authority over portfolio activity, to outright "turn-key" solutions, whereby all authority is ceded. Methodologies related to portfolio construction vary as well. Individually customized portfolios, fund of funds/manager of managers, asset class sleeves, and single consolidated funds are all approaches that have gained some degree of traction in the marketplace.

[1]Source: 2015 Outsourced-Chief Investment Officer Survey, Chief Investment Officer Magazine

Navigating the Noise

As mentioned above, the outsourcing concept is a comparatively new one and the different approaches available render it difficult to make direct comparisons across providers. Moreover, a lack of evaluation standards at the industry level makes comparison across providers somewhat more nuanced. To start, institutional investors would do well to evaluate their needs and goals, as well as their relative strengths and weaknesses in overseeing the investment portfolio. In addition to an assessment of the basic framework adopted by candidate providers, an institutional investor's due diligence efforts should thoroughly evaluate:

- The Provider Itself
  - Does the provider demonstrate a commitment to the business with requisite personnel and systems?
  - Does the provider have the financial resources in place to remain in the marketplace for a long time?
  - Does the provider have the knowledge and experience managing the type of asset pool being considered for OCIO?
  - Does the provider have a degree of independence – i.e., an ability to mitigate/avoid conflicts of interest?
  - How does the provider structure operational matters – e.g., middle and back office integration?

- Investment Expertise & Experience
  - What is the provider's performance? What is the extent of their "track record"? Is performance competitive and repeatable?
  - What are the credentials and stability of the investment team? What is their connection to the track record presented?
  - Does the provider have capable and experienced research staff?
  - Does the provider demonstrate a disciplined investment and evaluation process? Does the provider maintain adequate risk controls?

- Fees
  - To what degree is there transparency of fees?
  - What fees (e.g., provider fees, underlying investment manager fees, incentive fee structures, custody and trading fees, etc.) are present and how do they benchmark?

A Word About Transition

The manner by which a portfolio is built warrants particular and careful consideration. As the appeal and use of OCIO solutions continues to grow, requests to terminate services will inevitably arise. The way that the initial provider has built the portfolio can have far-reaching ramifications for the speed and the degree to which invested assets transition. Institutional investors would do well to incorporate this into their initial and continued due diligence.

A Fiduciary Decision

Institutional investors are facing an increasingly complex and challenging investment and fiduciary climate. As with any challenge, the market is providing solutions. The OCIO marketplace, however, is quite dynamic and fluid, with providers offering varied experience, investment structures, and value propositions. As a result, provider analysis and evaluation can be a challenging and time-consuming effort for many investment committees. The task is that much more daunting given the ramifications of an ill-conceived decision.

An organization must be prepared to undertake a thorough and honest audit of its particular needs, circumstances, and objectives to identify the approach that will best serve their needs. As with any fiduciary decision, employing a prudent due diligence process and documenting one's findings is the recommended course. Committees should also be mindful that, regardless of the magnitude of discretion that the organization ultimately cedes to the OCIO provider, as fiduciaries they retain a duty to oversee and monitor the provider on an ongoing basis.

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- Total Plan Fee Analysis (full fee disclosure);
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- Liability Driven Investment ("LDI") Strategies for Pension Plans;
- Quarterly In-Person Meetings with Finance/Investment Committees;
- Strategic Guidance on Relevant Topics of Interest;

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