The Outsourced CIO Model

By Gregory Curtis, JD

The outsourced chief investment officer (CIO) model for delivering financial advice has been gaining in popularity over the past decade. Clients’ requests for discretionary advice now outnumber client requests for nondiscretionary advice among many advisors. The purpose of this article is to define the outsourced CIO model, identify why it has become popular, and discuss its advantages and disadvantages relative to nondiscretionary advisory services.

Traditional Nondiscretionary Advisory Model

When investment consulting firms appeared in the early 1970s, their clients were huge pension plans and endowed institutions: the IBM pension plan, Harvard, the Ford Foundation. These giant organizations boasted in-house investment talent and investment committees populated by sophisticated professionals. They wanted to make all the important decisions themselves, and therefore they looked to consultants for recommendations only, especially regarding asset allocation and manager selection. In other words, investment consulting began, and remained for many decades, a nondiscretionary, advisory-only model for delivering investment advice.

Over time, smaller investors followed the bigger organizations’ lead and engaged investment consultants to advise them on portfolio needs. Because the consulting model always had been nondiscretionary it continued to be nondiscretionary, even though these new clients were different from the traditional consulting clients; typically, they lacked in-house investment talent, they lacked access to sophisticated investment committees, and their asset bases were much smaller.

The potential weaknesses of the nondiscretionary model for these new clients tended to be disguised by the long and powerful bull markets that characterized most of the 1980s and 1990s. But at the turn of the century the tech collapse caught investors off guard and clients began to consider the potential merits of asking advisors to take discretion over their portfolios.

What had been a slow-but-steady trend toward seeking discretionary advice became a stampede following the catastrophic market environment of mid-2007 to early 2009. And given the likelihood in the new normal investment environment of lower returns and higher volatility, we expect that the outsourced CIO model is here to stay.

Documenting the Trend toward the Outsourced CIO Model

According to a study by Casey Quirk (2008), fully outsourced assets from investors of all kinds have more than doubled in just the past four years. The same study reported that U.S. institutions will outsource more than half a trillion dollars in investments by the end of 2012.

Families and family offices are moving in this direction, too. According to Family Wealth Alliance (2009):

• Approximately four in 10 wealthy families have outsourced discretionary investment management and now use an outsourced CIO model.

• Among smaller family offices (those with up to $500 million in assets), two-thirds use an external advisor on a discretionary basis.

• One-third of all single-family offices surveyed reported that they believe they lack sufficient expertise to analyze investments themselves (up from 20 percent a year earlier). This rises to 50 percent for single-family offices with $100 million to $500 million in assets.

What’s Driving the Trend toward the Outsourced CIO Model?

The key investment issues that face all investors are selecting and implementing the correct asset mix for the portfolio, instituting good governance and policy implementation practices, engaging capable managers, and monitoring the performance and risks of the portfolio. This seemed to be a manageable task in the 1980s and 1990s, but over the past decade it has grown quite daunting. The variety of reasons for this complexity includes:

• More-volatile and more-difficult capital markets

• The perception that returns will be lower in the foreseeable future

• Limited investment resources at the client level, combined with rising costs

• The desire to add uncorrelated assets to the portfolio

• Difficulty accessing best-in-class managers, especially for hedge funds

• Difficulty in fulfilling fiduciary obligations in the wake of greater scrutiny and regulation of financial activity

• The overwhelming task of sorting through the plethora of financial instruments to determine the best fit for the portfolio
Acting with discretion allows advisors to demonstrate their value in bottom-line dollars. Historically, investors have been willing to pay high fees to money managers and hedge funds (which, on the whole, subtract value from portfolios) but have resisted paying substantial fees to investment consultants, which, on the whole, add significant value. By managing portfolios in a discretionary manner, formerly nondiscretionary advisors are able to demonstrate the value they add and, importantly, to get paid for it.

The Outsourced CIO Model Today

When investors talk about the outsourced CIO model, they are referring to the use of advisory firms to manage their portfolios on a discretionary basis, without seeking the clients’ consent (at least within limits) to make changes. Overwhelmingly, clients that hire discretionary advisors are hiring the same open-architecture firms that have operated on a nondiscretionary basis; these firms began offering discretionary management as a result of client demand. These firms are using the same tools they always have used with clients—skills in asset allocation, manager selection, and performance reporting—but they simply are exercising these skills on a discretionary basis.

Although each firm has its own twists on the model, in general the outsourced CIO model works as follows.

Establishing a risk budget. Because risk is by far the most important issue associated with managing portfolios, the advisor will work with the client to establish a risk budget for the account. Typically, this risk budget will be based on the expected price volatility of the portfolio, but it also may incorporate such risk-management metrics as expected downside risk, maximum expected loss over a given period of time, Value at Risk, and so on. The risk budget usually will be expressed as a long-term, strategic asset allocation target with ranges around which the portfolio will be allowed to depart from the target. Except with the client’s permission, the advisor may not stray from this overall portfolio design.

Tactical positioning of the portfolio. Ranges typically will be established to allow the portfolio to fluctuate above or below strategic targets, either as the result of market fluctuations or as the result of intentional tactical tilts imposed by the advisor. Again, the advisor may not exceed these ranges without the client’s permission.

Opportunistic ideas. One important way to add value to a portfolio is to allow it to take advantage of occasional opportunities made available by dislocations in the capital markets. The client and the advisor will agree up-front on the percentage of the overall portfolio that can be allocated to such opportunities.

Manager selection. In general, manager selection will be left entirely to the discretion of the advisor. However, client and advisor must agree on key issues such as the degree to which markets are efficient and, therefore, the relative allocation to active versus passive management.

Specific guidelines. If the client wishes to impose additional limits on the advisor’s discretion, those limits must be specific: prohibited investments, quality guidelines for fixed income securities, use of derivatives, socially responsible metrics, proxy voting, etc.

Performance reporting. Most advisors provide full quarterly reports with briefer monthly updates. If something more is desired, this will need to be negotiated up-front.

Unwinding trades. Most discretionary advisors will be willing to unwind any trade that makes a client uncomfortable, albeit at the client’s risk. However, this issue should be specified when the relationship is established.

The written policy statement. All the above, plus any other topics of importance to the client or the advisor, should be committed to a written policy statement, which will become the operating manual for the advisor who is managing the portfolio.

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Advantages of the Outsourced CIO Model

In deciding to engage an outsourced CIO, clients typically are seeking the following competitive advantages over investors who work with nondiscretionary advisors:

Reduced opportunity costs. In a nondiscretionary engagement, the advisor typically works on a quarterly cycle of issuing performance reports and making recommendations. (More frequent cycles tend to be cost-prohibitive except for the very largest clients.) Thus, one very important advantage of the outsourced CIO model is that opportunity costs are significantly reduced because the advisor formulates an investment idea and executes it almost immediately. Especially in the likely low-return environment of the new normal, minimizing opportunity costs matters more than ever. For many clients, this one advantage of the outsourced CIO model will prove to be decisive.

More sophisticated portfolio designs. If the client must make all decisions about the portfolio, it’s likely that the overall strategic asset allocation will be less sophisticated
than if the advisor was charged with day-to-day management responsibilities. Unless the client is a skilled investment professional, the client’s comfort zone regarding investment strategies is likely to be suboptimal.

**Expanded opportunity set.** As a corollary to the preceding point, outsourced portfolios tend to include more asset classes, more tactical bets, more opportunistic ideas, and so on, thus offering a higher probability of capturing market inefficiencies for the client’s benefit.

**Focus on the primary mission or interests.** The outsourced CIO model allows families to focus on their core interests and institutions to focus on their core missions.

**Enhanced fiduciary oversight.** If the comments made above about opportunity costs, portfolio design, and expanded opportunity sets are accurate, fiduciary oversight may be enhanced by moving to an outsourced CIO model.

**Eased diligence obligations.** When making the final manager selection decision, the client often will meet with the manager and/or conduct in-depth conference calls. After the manager is hired, the client may feel obligated to conduct periodic on-site visits, to hold regular calls, and so on. Many clients lack the time to carry out these diligence activities, and many others lack the skill to make them meaningful. Under the outsourced CIO model, the client delegates all this to the advisor, although the client usually can meet or speak with managers as desired.

**Disadvantages of the Outsourced CIO Model**

Certain disadvantages of the outsourced CIO model make it inappropriate for many investors.

**Giving up control.** Many investors want more control over their portfolios than is possible in the outsourced CIO model (though the control is often illusory, because most clients can’t effectively second-guess advisor recommendations).

**Selecting a poor discretionary advisor.** It’s very difficult to evaluate firms that are offering outsourced CIO services, resulting in potential danger that a client will have turned its capital over to an incompetent advisor.

**Investment education.** An investor can educate itself about portfolio management—and become a more effective client—by participating meaningfully in the portfolio management process. Outsourced CIO advisors also offer client education services, but many investors will find there is no substitute for getting their hands dirty.

**Cost.** Most advisors charge more for discretionary advice, so if cost is an issue this factor could tip the scale in favor of the nondiscretionary model.

**Selecting a Good Outsourced CIO Advisor**

Evaluating potential candidates for an outsourced CIO mandate is fraught with all the complexities associated with evaluating any new financial advisor plus a few wrinkles of its own. Here is a checklist of issues for clients to focus on:

- Many advisors advertising outsourced CIO services simply are responding to client demand and have little experience and few resources to support provision of these services. Tactical portfolio adjustments in particular can be dangerous if the advisor has little real investment experience.
- Is the advisor offering a one-size-fits-all approach? Especially when giving discretion to an advisor, overall portfolio design, risk level, and return expectations need to be tailored to the client’s unique objectives and risk tolerance.
- Does the advisor have a clearly articulated investment process that is applied uniformly across all portfolios? You want to be hiring a complete firm, not just a random advisor.
- How deep is the advisor’s experience in public and private markets? Hedge and private equity tend to be a lot more challenging than the long, public equity markets.
- How robust are the advisor’s manager selection resources? Are the most-senior professionals in the firm involved in manager selection, or has this important task been handed off to young analysts?
- Has the advisor put in place a sophisticated risk-management process? Portfolios should not be permitted to drift beyond specified ranges or the risk profile of the account can change wildly. The client should have a good understanding of downside portfolio risk and true diversification (assets that don’t suddenly correlate with each other in every negative market environment).
- Does the advisor have a culture centered on client relationship management? The advisor may be a good investor, but if he or she can’t communicate what they are doing and why, and be available to answer client questions, the relationship will be unsatisfactory.
- Does the advisor maintain relationships with multiple service providers? Is the firm able to “unbundle” such services as custody, brokerage, banking, etc.? Some advisors who claim to be open architecture are actually in bed with providers other than managers: custodians, brokers, private bankers, and so on.
- How deep is the performance reporting infrastructure? Are reports timely and accurate? Can the advisor offer customized reporting solutions?
- How transparent is the advisor with respect to underlying managers? Can the client meet and/or talk with managers directly?
- If the account is taxable, how much experience has the advisor had managing private capital? How actively are taxes managed and what techniques are used?

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- If the account is institutional, does the advisor have expertise in asset-liability management? Many institutional investors found themselves in trouble in 2008 when they dramatically underestimated their liquidity needs.

Summary
The outsourced CIO model is not right for every investor. However, the rapid growth in use of the model indicates that it is here to stay. Investors who have not yet considered discretionary management might wish to consider the advantages and disadvantages of this approach for management of their capital.

Endnotes
1 A recent National Association of College and University Business Officers (NACUBO)-Commonfund study of smaller endowments indicates that only 11 percent of funds between $100 million and $500 million employed in-house CIOs. The percentage for families is far lower.
2 “Opportunity costs” refer to the price movement that occurs between the time an investment idea is formulated and the time it is executed.

References