

# INVESTMENTS & WEALTH MONITOR

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## Outsourced Chief Investment Officer Growth in 2019: The Trillion-Dollar Slowdown

*By Charles Skorina*



**INVESTMENTS & WEALTH INSTITUTE®**

## OUTSOURCED CHIEF INVESTMENT OFFICER GROWTH IN 2019

# The Trillion-Dollar Slowdown

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**N**o one knows exactly when the southern cottontail rabbit diverged from its other 19 (or so) North American cottontail cousins, becoming its own distinct species of bunny. In evolution these things just happen.

Similarly, among financial institutions, modern banks seem to have evolved without fanfare from traditional money-lenders somewhere in northern Italy in the late 14th century.

More recently, the sub-sub-species of outsourced-chief-investment-officer firms (OCIOs) has emerged in a similarly low-key way from their various antecedent firms.

Our friend John Hirtle, of Hirtle, Callaghan & Co., claims that he (with fellow Goldman Sachs veteran Donald Callaghan) birthed the new OCIO species in 1988. The core idea was to offer a diversified and full-discretion money management function to family offices and others that no longer could effectively or affordably do the job in-house (even with the help of traditional trust banking services). The job was becoming too sophisticated and complex, both conceptually and operationally.

Observing their success, a number of other start-ups appeared; and a number of large, established investment management firms also joined the scrum.

Within a couple of decades, we have arrived at the OCIO landscape of today, managing not just billions but trillions of dollars, and reaping proportionate fees therefrom.

We've been charting the growth of the OCIO industry for the past decade, and the heirs of Hirtle, big and small, seem (mostly) to have flourished. In our 2019 report we observed that total OCIO assets grew from \$1.98 trillion to \$2.38 trillion. That's a year-over-year growth rate of 19 percent from 2018 to 2019.

That's pretty impressive. But, the assets under management (AUM) increase is not as vigorous as the annual growth we observed over the previous four years (2014 through 2018), some of which represents a "reclassification of assets" as reported to us by two major OCIO providers.

So, three decades into the OCIO era, we're prompted to ask whether the OCIO growth rate may be slowing, even plateauing. Are the OCIO rabbits multiplying faster than the green, green grass of customer money they live on?

Let's consider the evidence, both statistical and anecdotal.

### THE HARD NUMBERS

Eighty-three firms have updated their AUM and contact information for our database.

Outsourced assets as of June 30, 2019, topped \$2.37 trillion, up 19.4 percent—or \$386 billion more than the nearly \$2 trillion we reported a year ago.<sup>1</sup> Most—but not all—of these assets are from U.S. institutions and ultra-high-net-worth families. We estimate that about 10 percent of assets came from foreign entities, primarily the United Kingdom and the Netherlands.

A few firms dropped off our list thanks to acquisitions by Goldman Sachs (Aptitude and Rocaton) and Mercer (Pavilion and Summit Solutions), and a few others cut their losses and retooled their business models.

New firms joining the OCIO fray include a billion-dollar spin-out of the Oklahoma State University Foundation called MEMCO or Multilateral Endowment Management Company, with Kirk Jewell as chief executive officer (CEO) and Ryan Tidwell as chief investment officer (CIO).

### WHERE IS OCIO GROWTH COMING FROM?

At first glance, a 19.4-percent jump in outsourcing business seems healthy and auspicious. But there are caveats.

The \$147.6-billion jump in AUM at SEI and Wilshire was in large part a result of reclassifications, i.e., the money was already on the books in discretionary accounts and just moved to the OCIO column.

Remove Wilshire and SEI from our tally and growth for the rest of the group rose 12.6 percent. Still not bad, but now for a second caveat.

Six firms hold almost half the \$2.3 trillion on our list, and they did fine. (Note: At press time, two industry consulting—and OCIO—giants, Aon and Willis Towers Watson announced their intention to merge. Assuming the merger is completed, the new firm will hold more than \$430 billion of OCIO assets, almost two-and-a-half times

more than the next largest competitor, BlackRock.)

These big six—Aon, BlackRock, Goldman Sachs, Mercer, Russell, and Willis Towers Watson—manage \$1.07 trillion or 45 percent of the assets (mostly corporate pension funds), and they grew a robust 16.14 percent.

But the rest faced headwinds. Seventy-five firms, excluding Wilshire, SEI, and the big six, competed for the remaining business and gained a so-so 9.21 percent in assets.

This is a big come-down from the prior six-month jump of 17 percent that we wrote about in our June 2018 report and the 21-percent leap the year before.<sup>2</sup>

Our OCIO contacts offered a variety of reasons for this slowdown. The sector is more competitive than ever, bids and margins are collapsing by 30–40 percent (in some cases by much more), and the low-hanging fruit of past years—corporate pensions—are fewer and farther between.

So most new business will come from smaller endowments, foundations, health systems, charities, and associations—funds with less than \$1 billion in assets.

### CORPORATE AND PUBLIC PENSIONS: SLIM PICKINGS

Only about 300 multi-billion-dollar corporate plans remain in the United States that are managed internally. For those that decide to outsource pension management in the future, the six big firms mentioned above, along with major insurance companies, most likely will win the business. They have the size and resources to manage the funds.

As for public pensions, it is highly unlikely that they will ever be outsourced because the bureaucracy and politicians want control of the money. Only two public pensions in the United States have entered into an OCIO arrangement, and only one of the relationships continues in force.

In 2010, the San Diego County Employees Retirement Association outsourced its \$7.2-billion AUM

pension to Integrity Capital. Five years later the relationship was terminated with no love lost among the parties.

The second pension fund, the Montgomery County Employees' Retirement System in Pennsylvania, gave 90 percent of its retirement funds in 2014 (about \$1 billion) to Vanguard Group and the rest to SEI Investments. The funds were indexed and, so far, the trustees are satisfied with the arrangement.

### GLOBAL FACTORS AFFECT GROWTH

We can't cleanly separate endogenous growth of AUM versus new business or acquisitions, and we don't attempt to do so in tables 1 and 2. But we note that Boston Consulting Group says global growth of personal wealth had a compound annual growth rate of 6.2 percent over the four years 2013–2017 and only 1.6 percent in 2018.<sup>3</sup>

So, the (roughly) 19 percent year-over-year AUM increase we're observing in OCIO firms must be predominantly new business.

Table 1

## TOP 15 OCIO FIRMS BY PERCENTAGE GROWTH IN AUM

	Company Percentage growth in AUM	Percent increase in AUM	Dollar increase in AUM \$Billions	2019 Total Discretionary AUM \$Billions Jun/Mar 2019	2018 Total Discretionary AUM \$Billions Mar 2018
1	BNY Mellon Investment Mgmt. (3-31-19)	142.9%	\$11.00	\$18.70	\$7.70
2	Meketa Fiduciary Mgmt.	112.2%	\$8.30	\$15.70	\$7.40
3	LCG Associates (3-31-19)	83.8%	\$0.32	\$0.70	\$0.38
4	NEPC	53.7%	\$9.50	\$27.20	\$17.70
5	Angeles Investment Advisors	53.1%	\$1.70	\$4.90	\$3.20
6	BlackRock (3-31-19)	51.6%	\$64.00	\$188.00	\$124.00
7	Clearbrook Global Advisors	45.5%	\$0.38	\$1.20	\$0.83
8	Rockefeller & Co.	45.0%	\$4.90	\$15.80	\$10.90
9	State Street Global Advisors	35.3%	\$32.30	\$123.70	\$91.40
10	Cambridge Associates (3-31-19)	30.4%	\$9.10	\$39.00	\$29.90
11	DiMeo Schneider Associates (3-31-19)	30.0%	\$1.20	\$5.20	\$4.00
12	SunTrust Bank (3-31-19)	26.5%	\$2.70	\$12.90	\$10.20
13	Hall Capital Partners	23.7%	\$1.80	\$9.40	\$7.60
14	Arthur J. Gallagher	23.1%	\$0.60	\$3.20	\$2.60
15	UBS AG (12-31-18)	22.0%	\$2.80	\$15.80	\$13.00
	Average/Total	45.5%	\$150.60	\$481.40	\$330.81

(12 months ending June 30, 2019, unless otherwise noted)

**Table 2** TOP 15 OCIO FIRMS BY DOLLAR GROWTH IN AUM

	Company Dollar growth in AUM	Dollar increase in AUM \$Billions	Percent increase in AUM	Total Discretionary AUM June 2019 \$Billions	Total Discretionary AUM March 2018 \$Billions
1	BlackRock (3-31-19)	\$64.1	51.6%	\$188.0	\$124.0
2	Mercer	\$40.3	16.7%	\$282.0	\$241.7
3	State Street Global	\$32.3	35.3%	\$123.7	\$91.4
4	Goldman Sachs	\$27.1	20.0%	\$162.3	\$135.2
5	AON Hewitt (3-31-19)	\$14.6	10.7%	\$151.3	\$136.7
6	Willis Towers Watson (3-31-19)	\$14.0	11.7%	\$134.0	\$120.0
7	BNY Mellon IM (3-31-19)	\$11.0	142.9%	\$18.7	\$7.7
8	NEPC	\$9.5	53.7%	\$27.2	\$17.7
9	Cambridge Assoc. (3-31-19)	\$9.1	30.4%	\$39.0	\$29.9
10	Meketa Fiduciary Mgmt.	\$8.3	112.2%	\$15.7	\$7.4
11	Vanguard	\$8.0	19.1%	\$50.0	\$42.0
12	Morgan Stanley/Graystone	\$5.2	19.4%	\$32.0	\$26.8
13	Rockefeller & Co.	\$4.9	45.0%	\$15.8	\$10.9
14	Northern Trust	\$4.7	6.5%	\$76.8	\$72.1
15	Alan Biller & Assoc. (3-31-19)	\$4.4	9.8%	\$45.0	\$41.0
	Total/Average	\$257.5	23.3%	\$1,361.5	\$1,104.5

(12 months ending June 30, 2019, unless otherwise noted)

Table 1 ranks the top 15 firms by percentage growth in assets, whether the firm is large or small. The overall average AUM growth is 45.5 percent in this cohort.

Table 2 ranks the top 15 firms by dollar growth, again regardless of firm size. It includes some smaller and mid-sized firms that are doing some good marketing. Year-over-year AUM growth in this cohort is 23.3 percent.

### WHY OUTSOURCE?

For defined benefit plans, the driving factor is the pressure to meet challenging actuarial return assumptions in an environment of low expected long-term returns and an increasingly complex investment environment.

Defined benefit pension plan sponsors can't easily go to their participating employer(s) or employees for increased contributions, and they have no flexibility over committed benefit obligations. There are no rewards or promotions for meeting these obligations, but there are serious legal consequences for failing

to do so. It's understandable why they're looking for ways to outsource the headaches.

### PERFORMANCE: MANAGING MONEY IS COMPLICATED

Global multi-asset portfolios are complex and require time and resources to manage. Most corporations and nonprofit institutions don't want to spend the time and money on a function (asset management) that is not core to their mission.

The past few years have been great for all nonprofits—pensions, endowments, and foundations. But we can't forget that trailing 10-year returns still have been pretty poor for most institutions, with many falling short of their long-run targets.

Over the past decade, diversified global investment portfolios have underperformed index funds. During 2009–2019, the S&P 500 returned a beguiling 11.27 percent annualized, excluding dividend reinvest, and indexers could do no wrong.

Unfortunately, bull markets breed short memories. Few recall that during 1998–2009, the S&P 500 actually lost money, delivering a negative 2.72 percent (falling a calamitous 55 percent in the final two years, September 2007 to March 2009).

It's tough for boards to explain why their endowments or pension funds missed a bull market.

Meanwhile, cost pressures are increasing.

### COST: FOR SMALLER FUNDS IT'S USUALLY CHEAPER TO OUTSOURCE

Institutions outsource their investment management to reduce cost or to improve returns. Achieving both is even better.

Funds with more than \$1 billion usually have found it cost-effective to set up or maintain their own professionally staffed internal investment offices, but that's just a historical rule of thumb.

An OCIO typically charges 30–100 basis points of AUM, and some charge an

incentive fee on top of that. But, as noted above, increased competition seems to be driving fees downward.

For instance, consider a major deal reported in early 2018: the American National Red Cross (ANRC) in Washington, DC, tapped Cambridge Associates to manage its pension and endowment assets. That's about \$3 billion total, a piece of business that any of these firms would have been happy to land.

### HEADLINE RISK

The Red Cross deal is interesting because investment performance seems to have been good under former CIO Greg Williamson, who left in April 2018. But, as a nonprofit, ANRC is obliged to report CIO compensation on Internal Revenue Service filings for all the world to see. As a public charity soliciting donations, the board is sensitive about exhibiting that number. We have it on good authority that this was a major factor in their choosing to outsource.

Williamson's total W2 compensation at the Red Cross was \$795,036 in calendar year 2018, including a \$250,000 performance bonus for managing about \$2.9 billion. That's reasonable pay, in our opinion, for the size of the job and his credentials. It's in line, for instance, with college CIOs. But he was making more than any other ANRC executive, including CEO Gail McGovern, who made \$673,735.

Disclosing investment-staff compensation is a ticklish subject in the nonprofit world. Journalists went to court a few years ago to flush out CIO Erik Lundberg's full salary at the University of Michigan, and the school fought them all the way, even though state law seems to require disclosure of salaries at public universities.

### A SHORT GUIDE TO OCIO HAPPINESS

If you are a board member or senior executive and thinking about outsourcing the

management of your institution's assets, you should have good answers to at least two questions before you call any OCIO providers.

### FIRST, WHY ARE YOU THINKING OF OUTSOURCING?

Return envy? Peer institutions seem to be doing better than you are?

Sure, returns aren't everything, especially in the short term, and especially without taking risk-return balance into account. But you're tired of explaining that to your stakeholders and to journalists who report mediocre returns.

A high-performing OCIO might get you better returns. And, in any case, the onus can now be shifted partly to a big-name OCIO firm. The board would have done its duty by hiring top-tier experts, and that would make your life easier.

Meeting-fatigue? You're a smallish institution and you use a committee-and-consultant model. But the workload on your volunteer members keeps ratcheting up, and your selfless investment committee chair is retiring. Nobody else wants the job, especially not you, and setting up an internal investment office is not cost-effective.

Boards, you recall, are supposed to set policy, not manage. An OCIO is an actual manager. An OCIO could manage while your people set policy.

Again, your life gets easier.

Also, hiring internal investment staff is not so easy.

As a search-committee chairman remarked to me recently, there are very few Joe Montanas to be had among nonprofit CIOs. The accomplished stars and no-brainer candidates are mostly immovable.

That's obviously true among the mega-endowments. Seth Alexander, Andrew Golden, and Scott Malpass are happy

where they are (MIT, Princeton, and Notre Dame, respectively).

But much the same problem exists at smaller institutions. Proven leaders already are well-paid, or they're closer to the end than the beginning of their careers.

Paula Volent, for instance, has done a stellar job at the \$1.74-billion AUM Bowdoin College endowment, and her board is—wisely—taking very good care of her.<sup>4</sup> It's unlikely that another fund that size could match what's she's making.

Talent is still available at a reasonable price, lots of it. But you have to look deeper and harder and may need to move down to next-generation leaders who don't have the long track records that reassure nervous, meticulous boards. Next-generation candidates bring less hands-on experience and must survive harder scrutiny.

Big Fortune 500 firms like GE spend years and millions of dollars training their leaders for top jobs. Nonprofits don't have the time or budget for that. New CIOs must show up fully fledged and ready to hit the ground running.

OCIO firms offer the proven performance of those unobtainable superstars at a reasonable price. They replicate the entire investment office with the process and structure to cope with the complexity of modern portfolios and mounting operational and regulatory burdens.

An OCIO isn't necessarily the best choice for all institutions, but it's an attractive proposition for many.

### SECOND, WHAT IS AN EASIER LIFE WORTH TO YOU?

Good OCIOs—like good CIOs—are not cheap. If you prioritize cheap, then you shouldn't be thinking in terms of active investment management.

You probably know how much your consultants and external managers are

charging you in terms of basis-points-per-AUM-dollar to manage your money. But if an OCIO can get you an easier life, then what premium will you be willing to pay over that?

One caveat: OCIO firms have been reducing fees over the past year as competition for business has increased and the pace of outsourcing has slowed.

When and if you're ready to issue requests for proposals and interview OCIO firms, then it will be time to warm up the lawyers and accountants and do full-tilt due diligence. There are prefab checklists out there with many, many boxes to tick.

### HOW TO MEASURE OCIO SUCCESS

Different institutions have different goals. Every school has its own endowment payout rate and tolerance for risk. Some rely heavily on income, others place more weight on growing the principal.

It takes years to fully implement a multi-asset, multi-generational investment strategy, and altering course mid-stream (e.g., a new investment chair, a change in CIOs) can sap performance for a decade.

Trustees are responsible for setting investment objectives, and the OCIO firm is responsible for investment execution. The trustees, assisted by their OCIO provider, establish a policy portfolio that describes investment allocations to various asset classes based on risk and desired returns.

Board members review questions such as: How much do we invest in public markets? How much do we invest in alternatives (private equity, real estate, infrastructure, etc.)? How much risk are we willing to take? And, what are our cash return requirements and capital growth objectives over a period of years? Objectives also may include targeted investing for environmental, social, and governance objectives.

Each year board members also should ask: Have we met our targets relative to those benchmarks, net of fees? Did the OCIO firm add value? Did it add value in education, communication, and access to top managers? Was there chemistry between the fund and the OCIO firm? Was there OCIO team turnover? Did the original lead consultant stay with the account?

It's best practice for trustees and OCIOs to write everything down and regularly measure performance against the written objectives. Board members come and go and institutional memory fades. New board members often want to change an established policy or objective—which can hurt performance.

The challenge for the board and chief investment officer is to maintain course when market fluctuations shake conviction and crowd psychology rattles trustees. Most high-performance institutions have stable boards and long-serving chief investment officers or OCIO relationships.

### WHERE IS OCIO HEADING?

We expect OCIO growth to be healthy in coming years, but with year-over-year percentage growth tapering off to the low teens.

Corporations will continue to outsource their pensions to the largest outsourced managers on our list. And, as we mentioned above, we expect the rest of the new money to come mostly from sub-\$1-billion institutions (endowments, foundations, health systems, charities, and associations) and especially sub-\$200-million customers (ultra-high-net-worth individuals and institutions) as they continue to discover that OCIOs are both reliable and cost-effective money managers.

Our firm keeps a close eye on college endowments and, of the 120 or so with more than \$1 billion in AUM, only eight that we know of are currently outsourcing all or part of their assets: these

include George Washington University, the University of Richmond, Middlebury College, Smith College, Oklahoma State University, University of Arkansas, Syracuse University, and Iowa State University.

However, there are in total about 1,500 colleges and universities in the United States, thousands of foundations (about 150 with more than \$1 billion and another 150 in the \$500-million to \$1-billion bracket), and hundreds of health systems, charities, and associations.

We see no reason why the scale-economies for these smaller institutions shouldn't be very similar. As AUM growth begins to flatten, aggressive competition for new business among service providers makes the OCIO option more attractive and affordable to smaller organizations.

There's still plenty of green grass out there for enterprising OCIOs who have good reputations and know how to market their wares. ●

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### ENDNOTES

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