In April 2012 Chatham Partners LLC, a market research firm focused on the institutional asset management, retirement services, and global securities servicing markets, released its study entitled “Trends in Investment Outsourcing: Evaluating the Opportunity in a Recovery Economy.” This study of the investment outsourcing market focused on attitudes of respondents that outsource, perceptions of institutional buyers who have not adopted outsourcing, and provider approaches to the chief investment officer (CIO)/investment outsourcing market. The study defined outsourced CIO/investment services as follows:

Investment or CIO outsourcing is broadly defined as selecting a third party (such as an investment manager or consultant) to conduct various functions in the investment process. These may include manager monitoring, manager selection, asset/liability modeling, investment operations, or investment policy design. An investment outsourcing mandate typically includes the granting of some level of discretionary authority to the selected provider. (This differs from investment consulting relationships in which the consultant assumes no discretionary responsibility.)

When partial discretionary authority is granted, the outsourced provider may evaluate and offer recommendations to clients in areas such as asset allocation, investment products, or manager hiring/firing, or may help implement a strategy. However, the client is the final decision-maker. Complete discretionary authority enables the provider to make investment and/or allocation decisions, and to transact on the client’s behalf per the investment policy statement.

The survey’s specific topical areas included (but were not limited to): investment management approaches, level of discretion granted, drivers of the decision to outsource, provider selection and satisfaction, barriers to adopting investment outsourcing, and likelihood of adopting/expanding an outsourcing relationship.

Survey respondents included 215 institutional investors representing a cross-section of corporate defined benefit (DB) plan sponsors and endowments and foundations. Their assets ranged from less than $25 million to more

**FIGURE 1: FUNCTIONS PERFORMED INTERNALLY, WITH THIRD-PARTY ASSISTANCE, OR OUTSOURCED (FOR FIRMS THAT HAVE ADOPTED OUTSOURCING)**

**FIGURE 2: FUNCTIONS PERFORMED INTERNALLY, WITH THIRD-PARTY ASSISTANCE, OR OUTSOURCED (FOR FIRMS THAT HAVE NOT ADOPTED OUTSOURCING)**
than $1 billion, and exactly one-half are engaged in some level of outsourcing. Chatham Partners also surveyed 15 asset management and investment consulting providers for their perspectives.

Figure 1 shows activities that firms typically outsource if they engage in outsourcing.

Figure 2 shows activities that firms typically outsource for those firms that have not adopted outsourcing.

The key insight from this study was the following: “While there appears to be some merit to the market indicators portending an increase in institutional buyers’ appetite for investment outsourcing … growth in addressable markets may be more evolutionary than revolutionary.” The following findings support that conclusion:

- Moderate to low satisfaction levels with CIO/investment outsourcing providers
- Moderate up-sell potential within organizations that outsource
- Slowing rate of implementation
- Entrenched bias among organizations that do not outsource

Because these insights temper the publicized investment outsourcing growth projections, we thought it would be valuable to gain firsthand the perspectives of Peter H. Starr, president and chief executive officer of Chatham Partners.

The Interview

Judy Benson: Why did Chatham Partners undertake a study of CIO and investment outsourcing?

Peter Starr: We wanted to provide the perspective of institutional buyers—endowments, foundations, pensions, and other institutional entities—on the utilization of investment outsourcing arrangements. Much of the commentary and analysis we had seen was very optimistic, with glowing growth rates projected for outsourcing. But if we crunched the census, the projected growth seemed to be larger than what we know to be the standard uptake for these types of products in institutional markets because institutional buyers make very few explosive-growth purchasing decisions. They are a little slower, more cerebral, and more academic in how they select programs and investment products in general.

We decided there was a need to gain the unfiltered perspective of the institutional buyers themselves—something we had not seen in the existing research.

Judy Benson: What were the survey’s most significant findings? Any surprises?

Peter Starr: The survey confirmed that institutional buyers’ assessment and potential utilization of outsourcing programs represent a growth opportunity, but the growth will be more evolutionary than revolutionary. Institutional buyers have specific reasons why they would utilize one of these platforms, but they require answers to questions such as: Will outsourcing generate the outcome we expected going into the program? Will the outcome exceed what we could have achieved internally?

For the most part, we found a wait-and-see attitude. Satisfaction levels for institutional investors that have purchased partial or full discretionary outsourced platforms are not necessarily low, but they are not high enough to indicate that expected results have been achieved, particularly if results are measured over a one-, two-, or three-year decision timeframe.

We were surprised about the entrenched bias of those organizations that have not outsourced. They are not wavering in their decision, so they probably are not going to be a fertile growth market in the near future. That could change, but based on our research, the change will be slower, and not the explosive growth that many industry practitioners were looking for.

Judy Benson: Bottom line, what’s the biggest takeaway for asset managers?

Peter Starr: Growth is there, but asset managers must retool their approach to this market and the means by which they meet the needs of buyers more efficiently than they have to date.

Judy Benson: What do investment managers need to do to be more successful in this market?

Peter Starr: Three priorities. First, do a better job of defining investor expectations—better align the marketing message with what institutional buyers are looking for.

For example, when we asked institutional buyers about the most important factors in selecting outsourcing partners—in other words, what was most important in making the sale—far and away, the factors were asset allocation expertise, investment performance, experience with this specific investment style, and experience in outsourcing. These all revolve around investment performance and investment measurement.

In contrast, when we asked providers how they seek to differentiate themselves when developing their marketing for institutional buyers, they cited fiduciary services and diverse investment capabilities. There’s a misalignment because institutional buyers are looking for direct experience and performance within these types of structures, while providers are setting themselves out as strong providers of fiduciary services. In fact, only 21 percent of providers in the survey mentioned track record as something they speak to when creating their brand. If providers are going to be more successful, their first priority must be to focus specifically on program outcomes, experience, and expertise in providing those outcomes.

Second, providers must develop better metric-driven proof points on how they’re going to achieve outcomes and their historic success. If they have a track record, are they able to provide statistics or independent assessments showing that their clients are satisfied? In other words, provide concrete answers to questions such as: Can you do this for me? Have you done it for...
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others? If so, how successful have you been? How satisfied are your clients? The answers to these questions have not found their way into marketing messages, but it’s a critical component of the proof buyers want. Otherwise they are skeptical of the provider’s positioning or marketing message.

**Judy Benson:** And the third priority?

**Peter Starr:** Spend time eroding the barriers to outsourcing that exist, both among organizations that partially outsource and organizations that don’t outsource at all.

**Judy Benson:** What clues did the survey provide about addressing these barriers to outsourcing?

**Peter Starr:** As an example, institutional buyers may throw up the barrier that outsourcing won’t reduce their head count. However, the study shows that organizations that have outsourced have fewer internal resources than organizations that do not.

A second objection is: If I use an investment consultant, why would I need outsourcing? In fact, the study shows that organizations that outsource also use consultants. They just reposition roles and responsibilities.

In addition, there is a perception that outsourcing is expensive. Yet we found that the cost is generally less than 25 basis points for the pure outsourcing services, exclusive of asset management fees. In and of itself, a cost of 25 basis points is not wildly expensive.

Each of these barriers may be based more on hearsay, but providers need to separate myth from reality in addressing how outsourcing programs can help an organization. This must be a primary focus to be successful at influencing roughly half of the industry that, up to this point, hasn’t seen anything that they believe will be better, faster, or cheaper.

**Judy Benson:** To do a legitimate cost comparison, buyers must clearly understand their cost structure. Do they?

**Peter Starr:** Buyers do not accept the argument that costs will be reduced with an outsourced provider. Rather, they see it as an asset charge on top of investment fees. So their question is: Will outsourcing give me a better return than I already can get with the internal resources and research process already in place? It’s a big jump for many of these organizations to make the decision that an outsourced provider can be more effective and potentially more cost-efficient.

**Judy Benson:** Is it fair to say that the investment outsourcing model runs afoul of the investment consulting industry? How are consultants responding to this incursion?

**Peter Starr:** There’s a shifting of responsibility when an outsourced provider is used, but it does not eliminate consultants. They’re less deeply involved, which erodes their traditional revenue relationship with the client.

Many consultants have correctly taken the approach to compete by creating discretionary outsourcing platforms. They also argue that their independence, objectivity, and history with the client make them more-efficient outsourcing providers than, say, a large-scale money manager’s outsourcing platform. They’ve chosen to compete rather than trying to make the case that their institutional clients should stay with the traditional consultant arrangement.

(Figure 3 shows the level of discretion respondents are willing to grant to their CIO/investment outsourcing providers for different investment management functions.)

**Judy Benson:** The study found that defined benefit (DB) plans tend to outsource a greater proportion of fund assets than endowments and foundations. What is the explanation?

**Peter Starr:** That’s an accurate breakdown of the survey base, but it may not make it a proxy for the entire industry. Endowments and foundations have a different structure and more of an incumbency in terms of personnel. They also have a greater appetite for alternatives and noncorrelated asset classes, where outsourcing may make more sense. These firms have the internal capabilities to manage a long-only equity or bond portfolio and do not need to access additional expertise. As endowments and foundations become more reliant on alternatives and noncorrelated asset classes, outsourcing could make a lot of sense. In other words, buy expertise where expertise is needed.

**Judy Benson:** Would a similar argument hold true with DB plans when it comes to the ability to offer a liability-driven investment (LDI) strategy?

**Peter Starr:** LDI has been very successful for many organizations. Yet it is not an outsourcing arrangement, because there is no assumption of fiduciary discretion and oversight.

**Judy Benson:** The study also shows that more than half of the respondents...
that outsource CIO/investment services implemented those arrangements more than five years ago. Many fewer implemented an outsourcing arrangement more recently.

Peter Starr: Fifty-seven percent of respondents that currently outsource implemented their outsourcing arrangements more than five years ago, while only a surprisingly low 12 percent implemented in the past two years. This finding lends credibility to our assertion that growth rates may be slower than providers would have hoped. The market is there, but it’s not going to be low-hanging fruit for the next several years.

Judy Benson: Comment on the satisfaction levels of respondents with regard to the performance of outsourcing providers.

Peter Starr: Although we did not find a large proportion of dissatisfied organizations, only 23 percent reported that they are very satisfied with the outsourced provider’s investment performance. Organizations will not be likely to parse out more of their portfolios if they are not convinced that the desired outcomes are achievable by the provider.

Providers that successfully grow will be those able to achieve results for existing clients. The combination of investment results for your platform that show outperformance versus whatever are the selected benchmarks, combined with client testimonials/references about their results and satisfaction level, will be of more interest to potential institutional buyers than the strength of the fiduciary platform. The combination of results and satisfaction is a powerful message.

Judy Benson: Do clients have appropriate expectations of performance?

Peter Starr: Even though their expectations are being set by providers, client expectations are not unreasonable. Their expectations are fairly well-founded and logical. All areas of the survey sent a consistent message—performance is the top priority. This reinforces that providers must tell their story better; they need to focus their efforts on explaining the potential investment returns, rather than defining processes and organizational strengths. Emphasize outcomes first; process is a secondary consideration.

Judy Benson: Are fees a key consideration in selecting an outsourced provider?

Peter Starr: Fees are important, but they are not a primary driver of buying choices. When an outsourcing provider leads a sales talk with “We are the low-cost provider” or “We will save you X dollars,” it’s a non-starter. Ranked against the other decision metrics we tested, fees were not even in the top eight.

Judy Benson: Did that surprise you?

Peter Starr: No, it’s consistent with the institutional market, which has never been extremely cost-driven. The institutional asset management marketplace is fairly learned and appreciates the difference between cost-efficient outcomes rather than lowest cost.

Judy Benson: Any final comments?

Peter Starr: The survey demonstrated that organizations that outsource, and those that would consider an initial foray, require higher levels of support from providers than they need from their traditional relationships. For example, clients will require more extensive information about the process and outcomes, and more hand-holding to confidently report back to their various constituencies—investment boards, trustees, or CIOs. A provider’s investment in client service and communications support will pay dividends in terms of a more satisfied client.

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Endnote

1 Statistically the study found insufficient data to confirm a direct correlation between a high percentage of assets in hedge funds/alternatives and higher levels of outsourcing.