Trends in the Outsourced Chief Investment Officer Market

By Travis Pruit, CFA®

Outsourced CIO. Integrated, delegated, or discretionary CIO. Implemented consulting. A variety of terms are in use today for essentially the same service—that is, hiring an investment manager to provide total portfolio management services for a fiduciary portfolio such as an endowment or a pension fund.

Typically, this manager independently makes and executes a variety of decisions around such areas as asset allocation (both dynamic and strategic) as well as manager selection and replacement. These decisions historically have been under the purview of the organization's fiduciary committee, but a growing number of committees are now embracing the delegated model as a way to focus their energies on tasks more suited to their skill sets and to share responsibility for investment results.

Buyers for outsourced CIO services come from all the primary groups of institutional investors: defined benefit plans, defined contribution plans, and not-for-profits. As this submarket has grown, we've witnessed a number of trends that will impact the delivery and development of institutional portfolios in the future (see table 1).

Industry History

Commercial banks were the original outsourced CIOs. Bank trust departments ran balanced funds consisting primarily of domestic stocks and bonds for pension plans and not-for-profits in the days before defined contribution plans were commonplace. Over time, pension plan sponsors began to look to investment consultants for strategies, and forward-thinking universities pioneered new, innovative investment approaches. Institutional portfolios started to become more complex.

This complexity accelerated in the late 1990s with the technology boom, the increasing importance of 401(k) plans, and the unveiling of private equity, venture capital, and hedge funds to a broader investing audience. Modern portfolio theory and the endowment model led many institutions to embrace new investment solutions in an effort to generate greater returns. The concept of providing choice as a fulfillment of fiduciary responsibility led to a proliferation of 401(k) plan options.

Greater complexity coupled with two major stock market declines within a 10-year period fueled an appetite among institutional investors to pursue a different solution. Commonfund, perhaps the earliest dedicated OCIO of the modern era, began offering OCIO services to endowment and foundation clients more than 40 years ago. Mercer began providing delegated investment services to clients in Australia nearly 20 years ago and expanded those services to the United States in 2005. SEI transitioned its business from investment consulting to outsourcing in the 1990s, and The

Table 1: Investment Outsourcing Evolution

	Formation 1980s–1990s	Acceleration 2000–Present	Consolidation Present–2015+
Market Size	Very small market	Fast growing, sizeable market	Maturing market
Investing Environment	Persistent bull market	Highly volatile markets Decline of corporate DB	Continued high volatility
Demand Drivers	Demand for whole portfolio management	Capital market challenges (returns, volatility)	Buyer clarity on competitive models and what they want
Buyer Segments	Small institutions	Small E&Fs: adopt the "Yale" model	More mid- and large plan buyers
Competitive Landscape	Business extensions: consulting, manager-of-managers, investment managers	Rise of dedicated outsourcers and reception of distinct business model	Clear emergence of best practices and market leaders
Opportunity Sourcing	Relationship driven	Increasingly RFP driven	RFP driven

Source: Casey Quirk, "U.S. Investments Outsourcing Business Strategy," 2015, http://www.caseyquirk.com/page5.html

Investment Fund for Foundations was founded in 1991 to meet the investment needs of the not-for-profit community.

Since then, many others have entered the fray. OCIO search provider RVK, Inc., maintains a database on more than 80 OCIO firms. Each firm brings a different set of value propositions to the table, increasing the complexity of evaluating OCIO providers and complicating matters for investment committees seeking to simplify their jobs.

Improvements in Governance

A key objective of engaging an OCIO solution for institutional portfolios is to better leverage the organization's fiduciary governance approach by placing the authority for specific decisions with the entity best-suited to handle them. The broadening of potential tools and strategies by institutional investors to improve the odds of meeting objectives has increased the complexity of institutional portfolios and has placed challenging investment decisions into the hands of staff and committees that may not have the requisite expertise to be comfortable making those decisions.

Good governance is always essential, but it takes on increased importance with each additional layer of complexity. Within the not-for-profit market, good governance also must account for the challenges of dynamic volunteer committees and infrequent meeting schedules. The report "Endowment & Foundation Governance: Fiduciary Oversight and Implementation" addresses some of the challenges around fulfilling fiduciary responsibility and the need to adopt a rigorous governance process around the management of institutional portfolios.[1]

Figure 1 illustrates the risks associated with the traditional governance model. In light of these risks, OCIO solutions represent an opportunity for investment committees to delegate some of the activities that they historically have retained, including manager selection.

This can be particularly helpful for more complex approaches, such as alternatives, or for opportunistic strategies and dynamic asset allocation. It allows the committee to focus its primary efforts on maintaining appropriate overall risk/return balance relative to organizational objectives.

Trends in Defined Benefit Plans

Defined benefit plans were some of the earliest adopters of the OCIO model. Defined benefit plans have engaged OCIO providers in large numbers to improve the management of funded status liability and to de-risk portfolios. With the continuing trend among corporate sponsors toward closing plans and planning for eventual termination, sponsors are seeking to reduce the potential risks of a mismatch between liabilities and assets, which has the potential to require cash contributions to legacy plans. This situation is increasing sponsor appetite for more complex OCIO arrangements in which the OCIO monitors the portfolio and liability daily and actively adjusts the asset allocation to take advantage of shifting funded status levels.

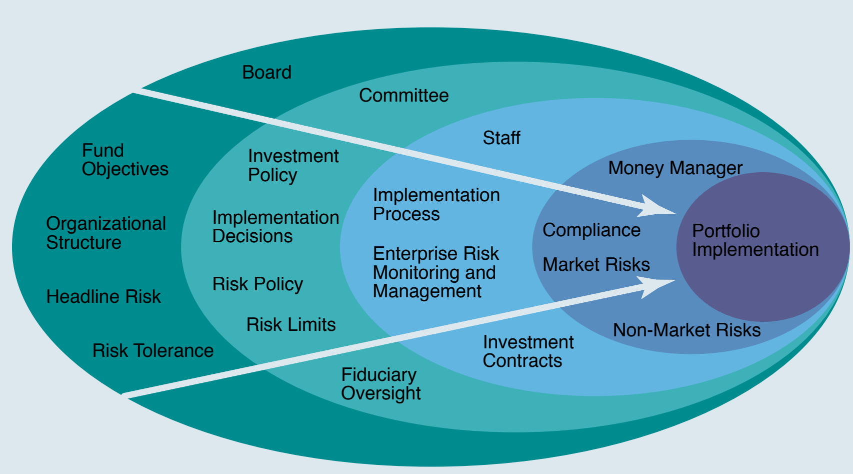
Additionally, plan sponsors are engaging with their OCIOs to better integrate ongoing investment strategy with plan termination strategy. For example, as funded status approaches market levels for plan buyouts, some OCIOs are actively transitioning assets into securities that can be provided in kind to the successor insurance company acquiring the liability. This type of asset planning improves the pricing that plan sponsors can achieve from the insurance provider, reducing the required funded level status and thus improving the economics of the overall plan.

Increasingly, plan size is less of a determinant as to who will engage an OCIO. An increasing number of larger plans are taking the outsourcing route. For larger plans, sponsors are inclined to engage an OCIO for a portion of the overall plan—say, for the liability matching fixed income allocation, or for a single-sleeve alternatives portfolio to support greater return potential but with lower overall volatility versus stocks.

Trends in Defined Contribution Plans

In the beginning, defined contribution (DC) plans were simple and usually had four investment options—capital preservation (money market/stable value), bonds, stocks, and a balanced option. As DC plans evolved to become the primary retirement vehicle for U.S. savers, the industry latched onto the concept of choice as a key way to meet fiduciary responsibility, unleashing a period of untethered growth in the number of options available to plan participants.

Figure 1: Risk and Governance Model



Source: L. Kunkemueller and F. Wood, "Endowment & Foundation Governance: Fiduciary Oversight and Implementation," May 2013, http://www.mercer.us/content/dam/mercer/attachments/north-america/us/mercer-government/EF_Governance_Fiduciary_Oversight_and_Implementation.pdf

As the industry matured, one could argue that the first stone cast in the OCIO evolution within DC plans was the mass adoption of target-date funds. In retirement plans that use target-date funds, participants define when they expect to retire and the professional investment manager handles the rest. The popularity of target-date funds highlights a growing trend toward improving retirement readiness, even at the expense of having boundless choice. This trend also underscores the idea that making millions of Americans the portfolio managers of their own retirement assets is perhaps not the optimal solution to meeting long-term retirement needs.

The Department of Labor signaled as much when identifying target-date funds as acceptable DC plan default options. Among larger plans, delegating responsibility for manager selection, asset allocation, and glide path design has gained momentum, and custom target-date solutions are becoming more common. Increased scrutiny on fees, transparency, and process has also influenced the views of corporate plan sponsors, whose staff often manage the retirement plans as a portion of their busy roles.

The level of OCIO engagement among DC plans may be one of the more surprising trends. For example, Mercer manages more than $20 billion today in U.S. DC plan assets and has found that large and mid-sized plans are a growing segment of the OCIO business. OCIO providers for DC plans are providing services that combine the strategic aspects of investment consulting with the benefits of scale through investment management, as well as efficiency through operational implementation.

OCIO engagements provide plan sponsors with the opportunity to potentially reduce overall plan expenses, improve manager performance and diversification, and efficiently operate within the confines of a well-defined investment policy statement. Large plan sponsors are moving away from mutual fund lineups into greater numbers of white labeled, separate account, and commingled fund solutions, in what might just be a return to the infancy of the industry.

Trends for Not-for-Profit Investors

Many consider that not-for-profit investors such as endowments and foundations have been slower to embrace OCIO mandates, but this is changing. As greater numbers of endowments and foundations consider migrating from the traditional advice model to an OCIO solution, we find they are looking for flexible design elements, whether through such features as maintaining a veto power over portfolio or manager decisions or by ascribing full discretion in some areas such as traditional manager selection while retaining advice-like relationships for alternative portfolios. Importantly, investment committees embracing the OCIO model are focused on receiving value for those actions that they don't believe they can effectively or efficiently apply.

Manager selection and replacement tends to be number one on the list of activities that investment committees seek to delegate, but increasingly we are seeing committees seek value from the OCIO provider through its ability to tactically adjust the portfolio. We hear periodically that buy-and-hold is dead, that investors will need to be more engaged and active participants to respond to a low-return and high-volatility market. However, OCIO providers may not be the best solution for this particular objective. The ability to tactically adjust a portfolio, and to do so both profitably and consistently, is a well-compensated skill in the investment management industry, largely concentrated in the higher margin hedge fund sector.

Those not-for-profits that were early adopters of the OCIO model are beginning to reassess existing relationships, recognizing that the landscape has changed remarkably in terms of active OCIO firms since they originally embraced the strategy. They have several years of experience with their incumbent firms and now are able to compare performance and portfolio construction techniques across a variety of providers and business models. We have witnessed an increasing number of request-for-proposal opportunities that are narrowed to "OCIO only" firms, reflecting some underlying bias in the buying market.

Like defined benefit plans, a growing number of larger organizations are embracing OCIO relationships. This is most apparent in the healthcare sector, where hospital systems with modest internal staff are tasked with managing substantial sums of operating, retirement, and foundation assets. It is not uncommon to see multi-billion-dollar OCIO opportunities across the healthcare market.

Finally, we see growing interest in integrating some form of environmental, social, and governance criteria, though investment dollars in this area remain limited.

Additional Trends

The trend of outsourcing assets has led some insurers to buy money management firms to serve their internal investment needs as well as to sell outsourced investment services to other insurance companies.[2]

Advantages and Disadvantages of the OCIO Model

For fiduciaries, we believe the primary advantage of the OCIO model is to simplify the governance structure and delegate an array of important activities to professionals dedicated to such pursuits, including manager selection and replacement, active rebalancing, and daily operational functions around the portfolio. Through an OCIO relationship, fiduciaries can better define and better measure progress toward success and hold the dedicated professionals more accountable.

In many advice relationships, it is unclear who owns ultimate responsibility for success or failure against the client's objectives. For example, the inability to make and execute timely decisions based off of an advisor's recommendations is often cited as a key reason that investment committees explore OCIO relationships. An inability for the committee to act on the advisor's recommendations increases the confusion around who is ultimately responsible for results. When the committee delegates activities such as manager selection, the onus of responsibility is clearer. Use of an OCIO offers the opportunity to provide more distinct measurement and determination of responsibility, allowing for more objective review of the value provided.

For a fiduciary to be successful, measurement criteria must be well-defined at the outset of the relationship and agreed upon by both parties. Dissatisfaction can come from a mismatch of expectations, e.g., an OCIO executes its strategy as defined but the fiduciary expected a different result. Clearly defining the intersection of expectations, philosophy, and benchmarking is paramount for setting the proper foundation for assessing the OCIO's performance.

Portfolio Management

An OCIO is tasked with rebalancing after a significant market correction, funding a good manager when performance is weak, and investing in a unique strategy—difficult tasks that committees historically have had a hard time effectively completing. The highest-value portfolio management decisions often can be the most uncomfortable to execute. Using in-depth knowledge about managers and portfolio management, OCIOs can make these tough decisions more effectively and improve overall portfolio performance and risk.

These challenges are particularly present with manager selection. When an advice consultant presents managers to a committee for inclusion in the portfolio, agency risk increases the probability that the manager selected is not the optimal one for the prevailing need. It is difficult for either party to focus entirely on the characteristics of the best fit because human behavioral factors often intercede. Delegating this decision allows the OCIO to craft a portfolio of characteristics across managers that improve the odds of meeting the client's objectives. This can include better integration of higher value-add strategies because the focus is on the portfolio rather than on the individual manager characteristics.

From a portfolio management perspective, the primary disadvantage for many committees is giving up control and the activities that go along with it. Meeting with managers is interesting, intellectually challenging, and frankly, it can be a lot of fun—it is a key draw for many not-for-profit volunteer committee members. Having a meaningful role in manager selection and portfolio management decisions provides emotional value for volunteer committee members, and there is risk that some may be less willing to commit their time under an OCIO relationship.

Cost and Operational Efficiency

The OCIO model is inherently structured to deliver cost savings to clients. The scale achieved through an OCIO provider should provide leverage to negotiate better economic terms or access with managers. Reduced fees or aggregation of client assets for purposes of a manager's fee-schedule waterfall often are available through an OCIO relationship. The opportunity within DC plans is a robust example. DC assets in the United States today are massive and growing, and the increased buying power of an OCIO can significantly improve the cost economics of plan options and improve the diversification of each option through custom white label funds or other OCIO-related commingled options.

Many OCIOs today have formed branded funds, which are access vehicles such as proprietary mutual funds or other commingled vehicles that combine client assets to deliver a diversified and cost-effective solution to the OCIO client. Manager changes, periodic cash-flow needs, rebalancing, and opportunistic allocations are delivered more efficiently across clients through pooled solutions versus direct manager positions. Some buyers of OCIO services see these funds as a conflict of interest, believing that the driver for such vehicles is increased compensation for the OCIO. Our view is more positive. For the largest swath of potential OCIO clients, today's institutional proprietary pooled funds are an efficient means to deliver on all aspects of the OCIO's value proposition.

The flexibility to change OCIO providers quickly and easily is an important assessment criterion for some OCIO end-users. Implementing through an OCIO's pooled solution may result in some restrictions relative to an otherwise direct portfolio, which may make for a more difficult divorce when the time comes to make a change. Additionally, organizational biases or requirements may necessitate holding manager positions directly. Therefore, for some buyers the prospect of using an OCIO's access vehicles will be less attractive.

Conclusions

The OCIO marketplace has evolved significantly from its origins in the trust departments of commercial banks. Many firms now hold themselves out as OCIO providers, and the breadth of service models, expected value added, and experience available from providers is expansive. Now, investment committees of all sizes and experiences are engaging with providers to reduce the impact of complexity, improve governance and implementation, mitigate fiduciary risk, and ultimately improve portfolio returns.

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Acknowledgment

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Endnotes

1. See L. Kunkemueller and F. Wood, "Endowment & Foundation Governance: Fiduciary Oversight and Implementation," May 2013, http://www.mercer.us/content/dam/mercer/attachments/north-america/us/mercer-government/EF_Governance_Fiduciary_Oversight_and_Implementation.pdf.
2. See Elana Margulies, "Outsourcing Trends in the Alternative Asset Industry from an Institutional Investor Perspective," October 13, 2015, at http://www.eisneramper.com/outsourcing-alternative-asset-ai-blog-1015.aspx#sthash.EsxkZKQ2.dpuf.