The Outsourced Chief Investment Officer

ACROSS THE GLOBE A ONCE FAMILIAR FIGURE IS INCREASINGLY ABSENT: THE CIO. A LOOK AT SOME OF THE TRENDS AND CONSIDERATIONS FOR OUTSOURCED CHIEF INVESTMENT OFFICERS.

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Budget pressures in a low return environment combined with increased investment complexity and regulatory/fiduciary risks, means that endowment boards and trustees across the globe are increasingly considering outsourcing their chief investment office. The growth of outsourced CIOs has been astonishing. It is estimated that for the last half decade CIO outsourcing has grown at a 10% compounding rate and that today the management of nearly half of endowment assets has been outsourced. This is particularly true for smaller endowments. In fact, less than 10% of endowments below $500 million employed in-house staff (*see 2009 NACUBO-CommonFund Study of Endowment results*). The trend has become so prevalent that today we have reached the interesting point at which the burden of proof for trustees is on in-sourcing. In other words, given the risks and complexity of managing the endowment in-house, boards today need to justify why not to *outsource*.

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What is Outsourcing

Outsourcing is a process under which the institution assigns the tasks of endowment management to an external provider. In this piece we will examine some of the risks and tradeoffs involved in outsourcing the chief investment office.

Outsourcing can be seen as an evolution of an earlier model where investment consultants provided endowments with investment ideas/opportunities. The outsourced CIO has a broad number of compelling advantages over the consultant model, but for this discussion we will focus on the legal and investment drivers that have created the momentum for outsourcing.

Legal Complexity

Fiduciary standards have now been almost universally accepted in the United States to provide for established investment experts to provide investment management. These standards are embodied in the *Uniform Code of Fiduciary Conduct* and *Uniform Prudent Management of Institutional Funds Act*. As a result of the adoption of these standards, the concept of a third party managing the assets (and the associated reporting, diligence, monitoring, etc.) on behalf of the endowment is increasingly commonplace. Indeed, most institutions find that an outsourced CIO model has increased fiduciary oversight.

It should be noted, however, that even with the broad acceptance of the practice of outsourcing, boards are still obligated to exercise due diligence and use reasonable judgement and oversight of the institution's assets. With that said, it is increasingly unreasonable to assume that a part-time/volunteer board can devote the time and attention and bring the level of investment and legal expertise necessary to serve as effective trustees.

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Investment Complexity

Alongside legal developments, the investment world has increased in complexity. The use of "alternative" investments by endowments to increase risk-adjusted returns has led to the dizzying growth of hedge funds and private equity. Alongside this growth, new "alternatives to alternatives" have also entered into endowment portfolios, such as timber, farmland, and catastrophe risk. At the same time, the rise of low cost exchange traded funds, has meant that exposure to traditional beta has become very inexpensive. These low cost funds have engendered a renaissance of new products: sector specific, country specific, currency linked, factor driven, etc.

This increased investment complexity means that to do the job of institutional investing properly, an in-sourced team generally needs to be large and comprised of a variety of specialties, which often means considerable expense. It is increasingly difficult for a small investment team to conduct the research, analysis, due diligence, and portfolio management required for a modern portfolio. Additionally, research is increasingly demonstrating that access to the best managers is a critical component of success in the "alternatives" area. Many endowments find that through outsourcing they are able to pool their assets with other similar institutions and gain access that they otherwise might not have had. Finally, the ability to allocate a portfolio tactically—to make changes to the allocation based on large changes in the economy—is difficult for a small team to execute effectively, particularly when burdened with the additional tasks already delineated!

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As more endowments are examining their own track records, a pattern of investment mistakes also begins to emerge. This list of common errors often includes:

1. Chasing past performance (when what has worked recently has a tendency to underperform in the future)

2. Exiting at the wrong time (usually the bottom)

3. Confusing market swings with asset class risk (and thus deeming an asset class as more risky than initially perceived)

4. Lack of discipline in rebalancing (as the only "free lunch" in investing, rebalancing is often delayed to wait for events—i.e. an election, Fed meeting, earnings announcement—or until the committee can meet again

5. Failure to reinvest cash aggressively, particularly when cash is returned in a lumpy fashion from private equity investments

6. Focusing on an asset and not the portfolio and the assets role in the portfolio

7. Micromanaging or under managing

8. Focus on committee member's legacy ("I don't want to lose money for the school under my tenure as a committee member")

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What to look for in an outsourced CIO

An outsourced CIO should be able to provide, if the committee desires, all or some version of the following:

1. Trust and custody service
2. Risk management and risk reporting
3. Investment manager due diligence, selection, and monitoring (along with a demonstrated willingness to "fire" bad managers)
4. Rebalancing
5. Development of a spending policy
6. Development of an investment policy statement
7. Asset allocation design and execution
8. Creation and maintenance of investment policy
9. Investment subscription document completion and cash transfer management for investment in and redemption from non-public investments
10. Performance calculation and analysis
11. Ongoing allocation management, rebalancing, and cash flow management
12. Annual audit process and tax filing
13. Reporting to, meeting with, and educating stakeholders (donors, board members)

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Conclusion

The sea change that recent years have witnessed in terms of the evolution of outsourced CIOs is likely to continue to gain speed as the trends that have propelled it in the past continue apace. Further regulation and greater evolution in the financial sector are likely. Additionally, trustees increasingly recognize the legal risks they take on personally, and to a lesser degree for the institution they seek to serve, by running an in-house endowment model. As such, we have entered into a new chapter of endowment management, one in which the burden of proof falls most squarely on those who do not, rather than do, outsource the chief investment office. ■

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