WHITE PAPER

To Outsource or Not to Outsource: The OCIO Question

The popularity of Outsourced Chief Investment Officers (OCIOs) has seen significant growth in recent years. By using an OCIO, institutions such as endowments and foundations transfer discretionary investment authority to an outside firm to manage some or all of the investment functions typically performed internally, such as asset allocation, manager selection and onboarding, custody, investment operations, and monitoring performance. According to *Pension & Investments*, more than $1.2 trillion in institutional assets are currently managed through the OCIO model.

continued on next page ›

More than $1.2 trillion in institutional assets are currently managed through the OCIO model.

DIVERSIFIED TRUST

diversifiedtrust.com

Unlike investment committees and internal staff at many institutions, an OCIO has the time, resources, and expertise to manage the full spectrum of critical investment tasks. An OCIO also has authority to make time-sensitive decisions without having to seek permission from the board or investment committee. OCIOs also protect board members, who are typically not investment professionals, from liability by sharing fiduciary responsibility.

This level of accountability is significantly greater than that of traditional consultants who serve as advisors only, not responsible for decisions, execution, or results. But OCIOs are not for everyone. There are disadvantages — institutions must be willing to delegate control and pay potentially higher outside costs. Plus, the investment committee and staff must maintain responsibilities that cannot or should not be delegated, such as developing an investment policy as well as vetting and monitoring staff and service providers.

This paper examines some of the pluses and minuses of using an OCIO, compares an OCIO to a traditional consultant relationship, and provides guidelines for choosing the arrangement that's right for your institution.

Rise of the OCIO

The advent of "open architecture" in the 1980s greatly expanded the asset classes available to funds and endowments, allowing for significantly more diversification. Consulting firms who had been operating as non-discretionary advisors realized they needed to be able to compete in this space to offset decreased revenue from fee compression. They saw an opportunity to become "Outsourced Chief Investment Officers" to manage the responsibilities associated with these new choices, even though few consultants had a track record serving in a discretionary role for clients.

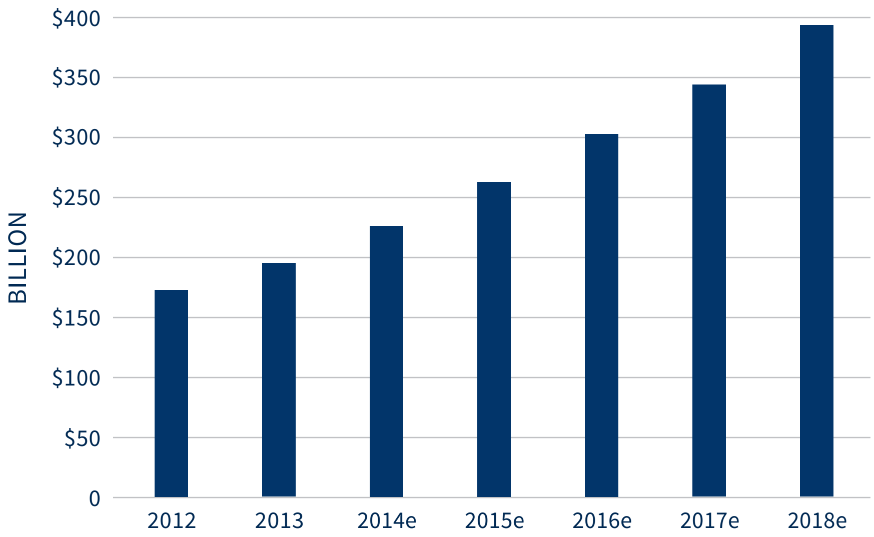
Former CIOs of endowment funds and large money managers also entered the OCIO space, joining independent firms with a history of outsourced, discretionary investment management.

Recent financial crises accelerated the move toward OCIOs. After the tech bubble collapse and the Great Recession, more and more institutions saw the value of an OCIO handling day-to-day decision-making and assuming responsibility for outcomes. Institutions preferred more attentive management of their portfolios to research and capitalize on opportunities and minimize missteps in a low-return environment.

continued on next page ›

This work gave OCIOs a chance to demonstrate — and get paid for — their value. And it took pressure off internal finance staff, who were typically overburdened and had minimal investment management experience.

Given these factors, the trend toward OCIOs likely is here to stay. But using an OCIO is not a magic pill. “It’s not a homogenous set of solutions,” says Sam Fraundorf, principal and chief investment officer at Diversified Trust. “It’s a service-focused way to meet the unique challenges facing each institution.”



2014 survey by Casey Quirk & Associates — projected the growth in usage of OCIOs by non–profit organizations.

The OCIO Model: A Look Under the Hood

A good partnership with an OCIO begins with proper planning — an institution must clearly define the relationship it seeks before it considers candidates and makes a choice. A key part of the process is determining the level of discretion that the OCIO will be given. Some institutions want their investment committees and staff to continue to be involved in all investment decisions. Others prefer to delegate the entire investment function to an OCIO and provide guidance only at the highest levels, such as setting strategic asset allocation targets. Still others prefer a hybrid arrangement — they may outsource only a portion of their assets or give partial management discretion to an OCIO, or they may use multiple OCIOs.

Once a partner is selected, the institution and OCIO work together to set general policy goals. “The OCIO will provide feedback on the existing investment policy statement or work up a new draft,” says Drew Berg, principal at Diversified Trust. “This clearly defines how the assets will be managed, how the work of the OCIO will be measured and who is responsible for what.”

continued on next page ›

Policy goals are established through a shared understanding of the institution, says Bill Spitz, founder and director of Diversified Trust. “A good OCIO will put a lot of time into a relationship to understand history, because history matters if you are going to make the right decisions,” he stresses.

The next important step is setting an overall investment strategy — determining appropriate allocation guidelines and whether to use active or passive strategies, or some combination of both — based on what the institution is trying to achieve. “You have to determine what job the money needs to do, then focus on how to structure the assets to do that job,” says Fraundorf. “The assets must be able to sustain some level of spend requirement. The higher the spend requirement, the more risk the fund must assume.”

The OCIO and institution also collaborate to establish a risk budget, which is a long-term, strategic asset allocation target with defined allowable departures from the target. This helps to set return expectations and determine liquidity and withdrawal needs.

Finally, both must agree on a customized asset allocation to meet the institution’s policy goals. Each asset class is given a target weight and range based on a strategic asset allocation analysis and the recommendation of the OCIO.

At this point, the OCIO typically assumes broad discretion in setting up and managing the portfolio, including:

- **Tactical allocation positioning**
- **Manager selection**
- **Diversification within classification/risk buckets**
- **Taking advantage of unexpected opportunities with a pre-determined percentage of the portfolio**
- **Investment cost management**
- **Performance reporting**
- **Custodian management**
- **Risk management**
- **Tax management - if applicable**

continued on next page ›

“A consultant recommends,” says Spitz. “OCIOs do.” So how much does this “doing” cost? Fees can vary, depending on the scope of delegation and degree of discretion, but they typically range from 30 to 100 basis points of assets under management. Because of this variance, it’s important to have a clear understanding of the OCIO service agreement:

- **Which costs are included in a fee and which will be billed separately?**
- **Will the OCIO fully manage the fund or share fees with sub-advisors?**
- **Will the OCIO charge an incentive fee or premium for specific services such as alternative strategies?**

Advantages: Why Put the O in Your CIO

Small-to-mid-sized corporate defined benefit plans, other private funds, endowments, and foundations are most likely to see the benefits of the OCIO model, largely because they typically have fewer internal resources than large funds. Advantages include:

- **Greater accountability** — Unlike a consultant, the OCIO assumes responsibility for performance. “We call this Plan Level Attribution,” says Fraundorf. “What is the impact of the OCIO’s decisions? Every penny is immediately demonstrated. Consultants don’t measure that.”
- **Economies of scale** — A good OCIO will bring to a small fund or endowment the benefits of a large one, with a much more affordable cost structure. “An OCIO may have billions in assets, so it can drive assets and pricing to the client’s advantage” says Fraundorf. “It’s like buying wholesale vs. retail. You normally can’t get that kind of purchasing power in-house.” With an OCIO, institutions can see reduced manager, fund, and strategy costs. “A good OCIO will structure fees entirely to the client’s benefit,” continues Fraundorf. “Any fee reductions should go to the client instead of being shared with the OCIO.”
- **Enhanced oversight** — An OCIO provides real-time management of the portfolio vs. management by investment committees that meet once a quarter. This helps to avoid “opportunity costs,” which are losses from price movement that can occur between the time an investment idea is formulated and when it is executed.
- **Reduced liability for directors** — Having an OCIO as a fiduciary can be especially appealing in today’s complex legal environment. “For many institutions, managing the investment function is just not worth the legal risk,” says Adam Dretler at Diversified Trust.

continued on next page ›

- **More sophisticated portfolio designs** — OCIOs typically have greater access to alternative investments such as real assets, hedge funds, private equity, and opportunities abroad, as well as greater experience in making tactical bets and capitalizing on market inefficiencies. Plus, OCIOs can bring added intellectual capital to complement the board's expertise, particularly when it comes to picking investment strategies, funds and managers.
- **Less work for the board and/or institutional staff** — Lifting this burden allows these people to focus on their primary responsibilities rather than investment management. "Decisions may fall on the committee, but execution falls on the staff, who typically have a higher and better use," says Berg. "For example, the annual audit for a fund or endowment can be highly complex. The investment components of that audit process are not the staff's area of expertise."
- **Cost savings vs. hiring internal staff** — Staff for major endowments are expensive both in monetary costs and management. Weighing this cost against an OCIO firm with deep resources may make more sense.
- **Improved documentation** — Including investment processes, procedures reporting, and compliance.
- **Greater access to needed technology** — Including risk management, cash flow modeling, asset–liability modeling, and more.
- **Greater consistency** — An investment committee may regularly change its portfolio strategies and its members. "Often, an OCIO can outlast committee members and staff," says Spitz, "so the OCIO can be the objective keeper of institutional history."

An Apples-to-Apples Comparison Should be at the Core of Your Evaluation

A board was looking for an OCIO to help manage its $80 million fund. Most bids came in at around 40 basis points, except for one that was about 1/3 of that cost. On the surface, this looked like an attractive proposition, but when the board dug deeper, it found that the low bid did not include an estimate of the expense ratios of the portfolio investment managers, which is a very important cost consideration of constructing a portfolio. Additionally, the low cost bidder- unlike the other proposals, which offered a flexible, open platform to meet the institution's unique needs, limited it's investment mix to managers who had a preexisting fee relationship with the OCIO's parent company. After this, the board chose another candidate.

"If all proposed fees are around a certain level except for a low-cost outlier, that's usually a warning sign," said Adam Dretler at Diversified Trust. "Proposals can vary greatly, and the only way to evaluate them effectively is to ask a lot of questions, understand the details and compare apples to apples.

continued on next page ›

- **Greater objectivity** — Maintaining an arm's length relationship from the client organization allows for well-thought-out decisions free from internal bias. An OCIO can provide disciplined, long-term institutional thinking at moments of panic or greed in the markets when human psychology usually works against investors.

A 2014 survey by SEI Investments found that most clients are satisfied with their decision to outsource. 84% planned to maintain or increase outsourced assets in 2015. "For most endowments, the burden of proof should be on why they don't outsource," says Spitz. "It's the difference between making major decisions in a 90-minute meeting four times a year, and having a skilled team of professionals working with you year round."

Disadvantages: Why Say No to an OCIO

Despite the rise of OCIOs, some institutions choose to maintain internal management of their funds, often with the support of a consultant. For the largest funds, it may not make sense to outsource when you have world-class expertise in-house and a consultant who complements that internal team by bringing new ideas to the table. Some of these funds believe that turning over responsibilities to an OCIO would hamper the development of their internal staff. And many funds refuse to work with an OCIO who does not offer open architecture and limits clients to their own products or products they are paid to use. "In this situation, you have no voice," says Spitz, "and if you make a bad decision, you can be stuck with it for years."

Cost can also be an issue. A non-discretionary consultant may only charge 10-30 basis points vs. 30-100 points for an OCIO. But OCIOs typically have far greater levels of responsibility, discretion, and time so an apples-to-apples cost comparison is always necessary.

Some investment committee members simply do not want to give up control of their funds. Fraundorf stresses that, before you can even consider bringing in an OCIO, you must first recognize your shortcomings as an internal fund manager. "If you aren't prepared to do that," he adds, "you're not ready to outsource." This kind of self-examination may not be a priority given the strong overall market performance in the years since the Great Recession, which perhaps has created a false sense of security.

Finally, many institutions do not have the experience necessary to evaluate OCIO candidates and are fearful of making a bad choice. "The confusion is real," says Dretler. "OCIOs can be brokers, money managers, consultants, or true fiduciaries of varying levels of prestige, experience, and size. And their approaches can all be different. There is no certification program for OCIOs, and the barriers to entry are low."

continued on next page ›

OCIO Vs. Investment Consultant

Institutions have traditionally looked to consultants to guide their investment committees in policy formation; research and propose potential managers; and assist with performance evaluation. Typically reporting to the investment or finance committee, consultants are a particularly good fit with boards or large family offices that have deep knowledge of investing and are willing to take on legal risk to make investments on behalf of the endowment. Consultants are also helpful to committees seeking new ideas, such as identifying talented new fund managers, or validating existing strategies.

As noted earlier, consultants don't charge as much as an OCIO, but their duties as an advisor are typically more limited — they are not accountable for decisions, execution, or investment results. The institution remains solely responsible for both strategic and tactical asset allocation as well as manager selection, but looks to the consultant for recommendations. And sometimes those recommendations can be less than specific. A consultant may present several different options and leave it up to the client to decide.

Here's a comparison of responsibilities:

TASK	TRADITIONAL CONSULTING	OCIO MODEL
Fiduciary Oversight of Investment Portfolio	Board Member/Trustee	Board Member/Trustee + OCIO
Defining Portfolio Objectives/Parameters	Board Member/Trustee + Consultant	Board Member/Trustee + OCIO
Determine Asset Allocation/ Investment Structure	Board Member/Trustee + Consultant	Board Member/Trustee + OCIO
Manager Selection, Termination	Board Member/Trustee	OCIO
Develop/Document Investment Process	Board Member/Trustee	OCIO
Contract/Negotiate with Managers	Board Member/Trustee + Consultant	OCIO
Ongoing Operational Management	Board Member/Trustee	OCIO
Education and Research	Consultant	OCIO
Performance Measurement	Consultant	OCIO
Recurring and One-off Reporting	Board Member/Trustee + Consultant	OCIO
Donor Advisement	Board Member/Trustee	Board Member/Trustee + OCIO

continued on next page ›

Is an OCIO Right for You?

Determining the answer starts with self-evaluation. Here are a few questions to consider:

- **Is using an OCIO even permissible?** — Your fund's governing documents may not allow for the shifting of investment authority. Can amendments be made to allow an OCIO to be a fiduciary?

- **Would the expertise of an OCIO be limited or wasted?** — The investment criteria for your fund may be so specific that you would never take advantage of all that an OCIO can bring to the table.

- **How important is protecting your institution and its board members from liability?** As mentioned earlier, managing the investment function internally may not be worth the legal risk.

- **Are you finding it difficult to attract an affordable internal fund CIO?** — As an alternative, an OCIO can provide top-tier capabilities without the costs of an experienced staff.

- **If you are using a consultant, what can an OCIO bring to the table that your consultant cannot?** — Even though your consultant is acting in a non-discretionary role, do you value his or her advice to the extent that the consultant is the de facto CIO?

- **Do you have internal resources to effectively select and evaluate the performance of an OCIO?** If not, do you have the budget to outsource that function?

- **Are you ready let go of day-to-day fund management?** — "You need to look in the mirror and ask yourself hard questions," says Spitz. "Do you have the time, temperament, and resources in-house? Do you want to make those big decisions based on committee meetings just four times per year? And you need to think about your relationship with your consultant. Is it dysfunctional? Do you even listen to your consultant? Based on your answers, it may be time to consider an OCIO."

continued on next page ›

Finding the Right OCIO: Experience Counts

Turning over fiduciary responsibility to an OCIO could be the most important decision you will ever make for your fund — and perhaps even your institution. In this case, there is no substitute for experience. The first thing you should seek is a partner with an institutional-level portfolio and a long-demonstrated track record as an OCIO. “I would suggest an OCIO with at least 10 years in the business and $1 billion in assets managed. At that point they have both experience and critical mass for executing their platform,” says Bill Spitz, Principal of Diversified Trust.

“It takes time to get good at this,” says Fraundorf. “Anders Ericsson suggested it takes 10,000 hours of practice to become world class at anything. It’s the same in our business.” Adds Berg, “A good OCIO has it in their DNA. It’s a very intentional part of their business.“

Even better, look for a firm that has experience on both sides of the table, with members who have managed endowments as part of an internal staff and/or served on investment committees. “Those are the people who know what you’re going through,” says Spitz.

Obviously, investment management performance is a factor, but look particularly closely at results during challenged market environments when strategies are truly tested. “Performance is not always the best indicator of a good OCIO,” says Berg, “but it’s a number to which people can relate.”

Other factors to consider include:

- Breadth of capabilities/services
- Reputation/recommendation from peers
- Value — Competitive price for the services provided
- Focus — Significant experience managing a fund of similar size or an organization with similar focus

“Performance is not always the best indicator of a good OCIO but it’s a number to which people can relate.”

continued on next page ›

- Ability/willingness to provide open architecture and tailor overall portfolio design, risk level, and return expectations to your fund's unique objectives and risk tolerance
- Clear definition of OCIO's fiduciary responsibilities and the institution's remaining liabilities
- A clearly articulated investment process
- Ability to maintain relationships with multiple service providers and "unbundle" services such as custody, brokerage, banking, etc. as needed
- Thorough, timely, and flexible performance reporting
- Transparency, particularly with fees and the use of sub-advisors.

Finally, look for an OCIO with a reputation for service. The responsibilities of an OCIO often go beyond investment management to include administrative functions like investment committee orientation and education, preparing the annual report, and more. "To do what we do well, you have to be service first," says Spitz. "Things come up that are not expected, like helping clients find tracking software or financing. Service-focused firms are more willing to be flexible." Adds Bell, "Find an OCIO who can partner with you. Outsourced doesn't mean forgotten. Both the OCIO and the client must be involved."

Even after taking all this into account, it can still can be difficult to evaluate a potential OCIO, especially if you haven't worked with one before. Partnering with a good advisor to help you with this process can be money well spent.

continued on next page ›

Important Notes And Disclosures

The Bottom Line

For many — even most — institutions, working with an OCIO can be the right choice. You will receive more proactive management of your fund or endowment, allowing you to take better advantage of opportunities and market shifts. You will also get the expertise and purchasing clout that a smaller fund normally won't have, without making a significant investment in top-tier internal staff. And you remove a burden from your internal staff and allow them to focus on what they do best.

The bottom line, of course, is that every institution, every fund, and every endowment is different, facing unique challenges that require custom solutions, which may include the use of a consultant, an OCIO, or some hybrid approach.

As institutions evaluate whether or not to outsource the CIO function, one question should always be asked — how can you maximize the efficiencies, skills, time, and effort of all groups involved, from internal staff and board members to consultants and possibly an OCIO. The answer should point you in the right direction.

BY:
ANDREW D. BERG, CFA | PRINCIPAL

R. SAMUEL FRAUNDORF, CFA, CPA | PRINCIPAL & CHIEF INVESTMENT OFFICER

WILLIAM T. SPITZ, CFA | FOUNDER & DIRECTOR

DIVERSIFIED TRUST

ATLANTA
400 Galleria Parkway, Suite 1400
Atlanta, GA 30339
Phone: 770.226.5333

GREENSBORO
701 Green Valley Road, Suite 300
Greensboro, NC 27408
Phone: 336.217.0151

MEMPHIS
6075 Poplar Avenue, Suite 900
Memphis, TN 38119
Phone: 901.761.7979

NASHVILLE
3102 West End Avenue, Suite 600
Nashville, TN 37203
Phone: 615.386.7302