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The OCIO Model: How Do We Measure Success?

KEY ELEMENTS

- **One of the critical challenges for outsourced chief investment officer (OCIO) services is measuring success, given the custom nature of these services.**
- **In our view, success depends on a handful of fundamental principles: keeping the best interests of the fund and its beneficiaries in mind; use of open architecture platforms; simple investment structures; close monitoring of agency risk; and successful management of client expectations.**
- **Given the expected growth in the OCIO industry, institutional investors will need to continue to evaluate the changing dynamics of this space and how service providers adapt to these changes, while keeping these core principles in mind.**

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Angel G. Haddad
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The outsourced chief investment officer (OCIO) industry has grown significantly over the last 10 years. Assets under management represent nearly $2 trillion and are expected to reach almost $3 trillion over the next several years.[1] Low barriers to entry have contributed to a proliferation of providers in this space, from boutique firms to larger investment management and investment consulting organizations. According to Cerulli Associates and Plansponsor, defined benefit plans and nonprofits with $250 million or less in assets represent the largest client base for OCIO services. Institutional investors with limited internal resources are particularly attracted to this model, as some do not have the capability to handle the complexities of less liquid and less transparent investments they may need to achieve desired return objectives.

A number of factors have contributed to this growth. According to Greenwich Associates, institutional investors hire OCIO providers to leverage investment expertise and to access previously unavailable investments. This includes direct partnerships in private markets or products with relatively large minimum investment requirements. A survey by *Chief Investment Officer Magazine* found that other factors include a desire for better risk management and additional fiduciary oversight.

Given the custom nature of these services, creating scale can be challenging, but it is paramount to support operational continuity and business success in the OCIO model. *Chief Investment Officer Magazine* suggests that, as this industry evolves, "the combination of scale, infrastructure, and results will increasingly matter and differentiate successful firms from marginal players."

One of the key questions for evaluating the performance of the OCIO community is: How do we measure success? We believe success needs to be evaluated on a case-by-case basis, factoring in a number of client-specific considerations. Performance evaluation often goes well beyond simply "investment results." While investment performance is very important, we believe monitoring OCIO performance needs to incorporate factors specific to the services in question.

For example, some OCIO relationships provide partial discretion on investments and more support for operations, implementation, and monitoring. In this case, operational efficiencies help define success. In other cases, clients may retain an OCIO for fully discretionary investment mandates in which performance becomes an important component of the value proposition.

Irrespective of the service provided by the OCIO, we believe success depends on these fundamental factors:

1. **Keep the Best Interest of the Fund and Its Beneficiaries in Mind:** A fundamental principle in supporting the investment needs of clients is to keep the best interest of the fund and its beneficiaries in mind in everything we do. This is particularly important for OCIO mandates given their custom nature and the need to manage multiple variables to enhance the potential for competitive performance.

1 Sources: Chestnut Advisory Group, "Maximizing the OCIO Growth Opportunity"; Plansponsor, "OCIO Model Gaining Ground with Variety of Investors"; *Pensions & Investments*, "OCIO Managed Assets Leap 23%"; Cerulli Associates.

2. **Open Architecture Platforms:** OCIO platforms vary greatly in the depth and breadth of their products. Some follow an open architecture approach, with best-in-class products at competitive fees, while others offer only proprietary funds or single fund/product families. In our experience, open architecture platforms offer a better opportunity for implementing best-in-class mandates, as no investment manager is proficient in every asset class it offers and model portfolios may not meet the needs of every client. This approach also helps eliminate potential conflicts of interest inherent in a proprietary fund framework.

3. **Power of Simplicity:** Our experience suggests that complexity can translate into mediocre performance and relatively high fees. We believe in keeping investment structures relatively simple, without needing to sacrifice sophistication or diversification opportunities. We believe that each component of a sound investment structure needs to play an important role in the overall portfolio in terms of enhancing diversification and risk-adjusted return potential. In some cases, as assets grow, investment structures become more complex to take advantage of specialized strategies. Even in these circumstances, we believe in reducing complexities and introducing efficiencies in implementing a sound manager structure.

4. **Monitoring Agency Risk:** OCIO services can be subject to factors contributing to agency risk. Here are some of the common risks we believe need to be monitored closely:
    a. **Fees:** Underlying product fees may be higher for some OCIOs compared to alternatives. Fee negotiations should create value for the exclusive benefit of the client. Unfortunately, some funds with relatively small asset pools end up paying a premium for certain investment exposures. Creating scale can help mitigate this risk. Fee transparency is also very important. The fund sponsor needs to be aware of the fee structure to ensure that common interests are aligned appropriately. The sponsor should be able to understand:
        1. How the OCIO is compensated.
        2. What administrative costs are covered by the plan.
        3. How the underlying investment managers are compensated (e.g., directly by the client or through the OCIO fee structure).
        4. How much the underlying managers are paid.

        We believe this level of transparency is very important for the success of a discretionary institutional investment program.
    b. **Tactical Approaches:** OCIO service providers usually command a premium for tactical positioning to take advantage of short-term market anomalies for alpha generation. However, in our experience, managers have had limited success creating value consistently using this approach. Some OCIOs have been reluctant to use the full breadth of their risk budgets for value creation. Some have expressed concerns about recent spikes in market volatility and have taken a more cautionary position in their risk positioning. While this may be justified, it also raises the question of the manager's value proposition regarding a tactical approach. If the client is paying for tactical asset allocation, the OCIO should take advantage of these market dislocations for alpha generation. Otherwise, why should the client pay these fees? We believe

fee structures need to be aligned with the best interests of the client in mind. Excessive or unnecessary fees contribute to value destruction.

c. **Manager Selection:** The quality of the OCIO's manager selection process has implications for the client, mainly in terms of performance, manager turnover, frictional costs, and the potential for conflicts of interest. OCIO providers need to have a well-documented manager search process that supports quality, operational efficiencies, value creation, and operational continuity to help identify long-lasting product solutions for clients. The process needs to avoid a manager-selection process driven by any economic interests between the OCIO and other third parties and needs to focus on identifying the best possible product solution for the mandate in question.

5. **Managing Client Expectations:** We believe it is important to set realistic expectations with clients to make sure they understand the full range of services offered by the OCIO and its limitations. With the expected growth in assets in the OCIO space in the next several years, many providers are trying to expand their business. There is a fine line between employing aggressive sales practices in pursuit of new business and setting the right expectations with clients and prospects. This dynamic may tempt some service providers to over-promise and under-deliver, impacting the quality of their services and contributing to a situation that may not be sustainable or tolerated by clients. In our experience, some OCIO service models have failed because of this particular issue.

Given the expected growth in the OCIO market, institutional investors will need to continue to evaluate the changing dynamics of this space and how service providers adapt to these changes. Successful OCIOs will continue to evolve, with a focus on the clients' best interests, consistent with their fiduciary responsibilities. This focus will help all strategic competitors differentiate their services from marginal players that ignore some of the most fundamental principles for growth and success in this space.

About the Author

Angel G. Haddad is a senior vice president in Callan's New Jersey Fund Sponsor Consulting office. He joined Callan in June 2012. Angel works with a variety of fund sponsor clients, including corporate and public defined benefit plans, corporate defined contribution plans, and nonprofits. His client responsibilities include strategic planning, plan implementation, investment monitoring, and coordination of special client projects.

Angel earned a BBA and MBA from the City University of New York—Baruch College, the Zicklin School of Business.

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