MESA INVESTMENT CONSULTING

Current Considerations in CIO Outsourcing

Overview

Over the last decade fiduciaries of institutional investment portfolios have increasingly decided to outsource investment decisions to third parties. Under this operating framework, a third-party provider assumes discretion over all, or some part, of the investment program and in doing so directly assists the sponsor in fulfilling their fiduciary duties. This form of investment outsourcing is commonly referred to as outsourced CIO or OCIO.

We revisit the topic of hiring an OCIO in this updated paper. An update to our 2012 topical paper is appropriate given the number of investment programs that have been operating under the OCIO framework for years now after having made the switch from using a traditional non-discretionary investment consultant. The goal of this paper is to explore key considerations in investment outsourcing, the merits and risks of engaging an OCIO, the need for ongoing sponsor diligence and current market dynamics.

Rationale for Outsourcing

The decision to outsource is an important step for investment program sponsors. There are a variety of factors that drive the decision to outsource investment decisions. Some of these factors include:

- Increased global market complexity
- Limited staff, board and committee resources including the impact of turnover
- Need to streamline decision making
- Achieving funding goals

The decision to outsource and the kind of solution employed will be dependent on multiple factors unique to each institution. Sponsors of smaller asset pools often have limited resources to oversee investments and stand to benefit from more professional management while larger asset pools may find it more effective to outsource given portfolio complexity and internal resource constraints. Further, an outsourced provider can assist with operations, administration, legal and compliance, in addition to providing access to more robust analytical and risk management systems and knowledge of other vendor capabilities (e.g., custodians).

Many investment program sponsors find that there are oversight limitations associated with volunteer investment committees and boards that meet only periodically. As markets have become more volatile, fiduciaries and their advisors recognize that prompt responses to market conditions are needed to improve portfolio performance. Investment committees often meet only quarterly, making tactical or opportunistic shifts in portfolios difficult to achieve in a timely manner as they review and vet opportunities and ways to implement them. Timely responses to changes in markets serves to reduce opportunity costs. Allowing an advisor more discretion in making tactical shifts in portfolios as market conditions dictate should reduce opportunity costs.

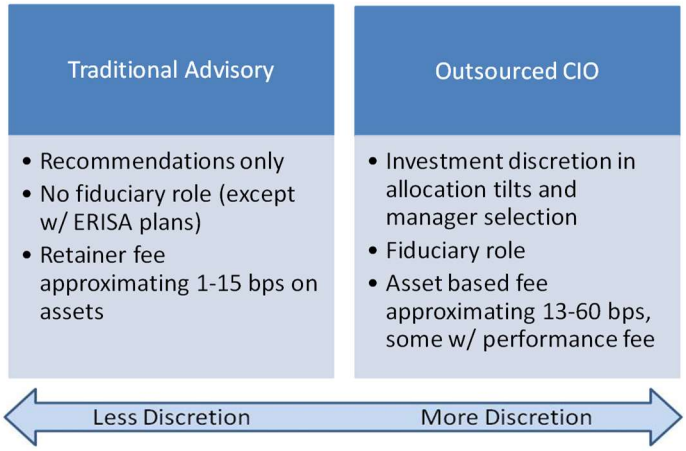
There is agreement among many fiduciaries that closer and more frequent monitoring of portfolio exposures, risks and performance, in addition to a more robust risk management process would be beneficial. Hiring an expert and outsourcing these functions makes a lot of sense for many institutions.

Taking a thoughtful inventory of the reasons for pursuing investment outsourcing, and quantifying the costs and benefits, should be the first step in making the decision to outsource. An outsourced solution should only be implemented if it meaningfully increases the probability of a sponsor meeting its investment goals, mission and fiduciary responsibilities. Choosing the right OCIO provider is also critical in ensuring investment program success.

Spectrum of Advisory Services

There are a variety of advisory services available to asset owners and investment program sponsors. The nature of an advisory engagement will depend a great deal on the sponsor's goals, resources and the level of control they wish to maintain over investment decisions.

Service terms associated with investment advisory engagements vary but ordinarily they fall within two broad categories – non-discretionary and discretionary. The following diagram depicts typical service arrangements available in the market. In general, the greater the level of discretionary authority, fiduciary responsibility and services assumed by the advisor, the higher the fee.



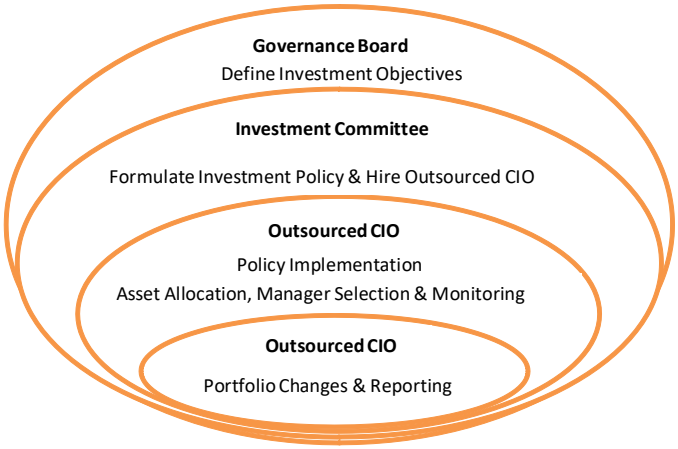
Practical Application

Once the reasons for outsourcing are deemed compelling enough and worthy of pursuing, employing a solution will involve a number of steps prior to implementation including:

- A governance structure review
- Identifying which roles and responsibilities to outsource
- Identifying the characteristics desired in a fiduciary partner
- Setting investment policy and defining roles, responsibilities and mechanisms for on-going monitoring and review

Governance

Under an investment outsourcing engagement, the sponsor board and investment committee will continue to be closely involved. Sponsors will typically have responsibility for investment program oversight, investment policy statement and guideline development as well as setting strategic asset allocation policy targets. While the approval of an Investment Policy Statement (IPS), a key governing document for the investment program, will continue to be the responsibility of the sponsor, the implementation of policy will be the outsourced provider's primary responsibility. The diagram below depicts what a typical governance structure would look like.



Under this framework, the primary governing body or board will define objectives and have broad oversight and fiduciary responsibility. A committee appointed by the board will establish policy consistent with objectives and will likely work with the outsourced provider to establish how policy should be implemented including the setting of risk budgets and portfolio design, strategic asset allocation targets and permissible ranges, along with liquidity requirements.

There should be some discussion between the sponsor and outsourced provider on use of any of the OCIO firm's proprietary funds as they may not represent best-in-class or compelling enough offerings to permit their use in the portfolio. Other areas of discussion would revolve around the use of active versus passive offerings across select asset and sub-asset classes. Further, the policy statement and portfolio guidelines may be structured to include wider, more liberal target allocation ranges or an allocation for opportunistic investments to allow the OCIO greater management flexibility.

Once the sponsor has approved investment policy, the outsourced provider will be responsible for the execution and implementation of policy, which consists of portfolio construction. As a practical matter, constructing and managing the portfolio will involve asset allocation changes within permissible ranges (tilts) and rebalancing, investment manager due diligence, fund selection, monitoring and client reporting. These are critical investment functions and the third-party OCIO provider, in assuming discretionary authority, will act as a fiduciary alongside the sponsor.

From the onset, it will be important to establish metrics to measure success over time including incorporating a description of these methods in the Investment Policy Statement. This would include establishing policy, peer and market-based performance benchmarks and ensuring that OCIO reports to the sponsor provide portfolio performance relative to benchmarks and peers in a manner that is clear and consistent. Reports should be structured in a way to provide performance and exposure information on the total portfolio and across underlying assets classes which are sufficiently clear to prompt the sponsor to ask the right questions.

Selecting an Outsourced Provider

There are more than 75 firms currently offering credible investment outsourcing services for institutional investors. Providers include pension consultants, specialist OCIO firms, investment management firms and wealth management firms. These providers offer a wide variety of solutions. Some offer a customized approach while others offer prepackaged solutions or their own funds management services. Further, each firm has different capabilities, skill sets and resources, making conducting an advisor search and sorting through prospective candidates a time-consuming task for sponsors.

Selecting the right provider would require that the sponsor identify procedural and operating requirements, the characteristics desired in a portfolio and fiduciary partner, and engage in a thoughtful screening of options, a disciplined evaluation of a manageable list of potential candidates, and a thorough due diligence process. At a minimum, the process involves gathering qualitative and quantitative information from prospective providers, synthesizing the information, selecting several candidates, and conducting interviews and onsite visits before making a hiring decision.

The following table describes the types of organizations offering investment outsourcing services, and how they generally compare along different dimensions. While we do not ordinarily like to generalize, we thought it useful to provide

broad observations on the different types of providers given our experience in the market. We would stress that each firm is unique in its history, accomplishments, offerings and capabilities. We have found several highly competent providers across all OCIO provider types.

Outsourced CIO Providers

OCIO Type	Strengths	Weaknesses
Pension Consultants:	Strong client service model	Motivated to offer OCIO services given client demand & higher fees
	Open architecture in use of unaffiliated manager funds	Relatively new providers of OCIO services; less experience in managing portfolios
	Experience in asset allocation & manager selection	Navigating discretionary versus non-discretionary client allocations
Specialist OCIO Firms:	Focused business model	Generally new and smaller boutique firms
	Endowment experience, strong industry contacts and fund access	Often operate with key man risk and more limited staffing
	Open architecture and alternative investment focus	Infrastructure and operational resources less robust
	Experience in asset allocation & managing portfolios	OCIO management fees tend to be higher
Asset Mgmt Firms:	Usually large multi-product firms	Tend to be asset gatherers and product providers
	Experience in managing securities, and increasingly multi-asset class solutions portfolios	Client service model not as well developed
	Depth of resources	Tend to use own asset management products; more prone to conflicts
Wealth Mgmt Firms:	Longest tenured OCIO providers	Focused on serving high net worth and related foundation clients
	Asset allocation, fund selection and portfolio management experience	Tend to use own asset management products; more prone to conflicts
	Good infrastructure and depth of resources	Organizational complexity

Considerations in Investment Outsourcing

There is a great deal to consider when hiring an outsourced CIO provider. The sponsor-advisor fiduciary partnership is an especially close one. From the onset, it will be important to set clear guidelines and expectations. Besides hiring a provider with strong client service skills, there is a whole host of other considerations that will determine the success of the relationship.

Service Offerings

Service offerings are one of the most important criteria used in an initial screen of potential providers. The sponsor's mission, goals, objectives, and procedural and operating requirements will drive the types of candidates considered during a search. For example, some providers offer manager of manager commingled fund solutions while some use their own fund management services and others offer open architecture offerings utilizing unaffiliated manager funds. There are those that offer a more limited selection of solutions (e.g., a "one size fits all" approach) while others offer greater customization, separate account models or particularly good knowledge of and access to alternative investment strategies.

The type of service offerings, market coverage and key competencies of the provider, including asset classes utilized and experience across various markets and mandates, will be important considerations in a search. These characteristics will tend to drive the composition of the provider's client base as well. While the provider's existing client mix should be a consideration in conducting an evaluation, we would caution against using their current client base as a primary determinant in selecting a provider. Taking a holistic approach, and thoughtfully matching sponsor needs and provider offerings and competencies, when conducting a search, yield the best results.

Fees and Cost Considerations

Fees for outsourced engagements vary and are as diverse as the number of product offerings in the marketplace. In general, fees have drifted lower as more providers have entered the market offering their own multi-asset class solutions. A thorough analysis comparing OCIO and underlying fund fees and expenses for each candidate's proposed portfolio are essential to any search. An all-in fee analysis should include a comparison to the sponsor's current advisory relationship and portfolio holdings. Understanding the OCIO provider's view on use of active versus passive strategies and alternative investments will be integral to the analysis.

Performance track record

Outsourced providers offering commingled fund solutions will likely have performance track records that meet investment management industry reporting and verification standards. However, outsourced investment assignments are often customized and as a result comparing performance across OCIO providers and benchmarks can be a challenge. Consequently, performance analysis will require a critical eye and careful analysis of comparable client portfolio performance and benchmarks to be useful. Further, because there are many new entrants in the OCIO industry, track records are often short and will not provide enough insight into the provider's level of skill. A holistic approach to outsourced provider evaluation, incorporating both quantitative and qualitative criteria, will be necessary.

Organizational Structure

A review of the OCIO firm's origins and history, ownership, organizational structure and business mix should yield important insights about the candidate firm including:

- Business objectives, commitment and what drives strategic business decisions

- General competencies, resources and resource allocation
- Ability to attract and retain high caliber talent
- Objectivity and conflicts of interest

A proper level of due diligence will increase the likelihood that a sponsor will find a provider that is the right fit and has interests that are closely aligned. For many sponsors, that means identifying an organization that is stable and committed to the business, is objective, and motivated to provide best-in-class offerings with a client's needs and goals in mind. Clients need to be mindful of a provider's motivations, particularly asset gathering mandates for those with internally managed products, and related businesses, which stand to benefit from growth in investment outsourcing.

Experience

Each OCIO provider type has their relative strengths and weaknesses. Traditional investment consultants are motivated to pursue discretionary assignments to meet growing client demand and to demonstrate their ability to add value more directly. In addition, fee for service differences are substantial with non-discretionary advisory retainers being as low as 1-5 basis points on assets versus multiples of that for a discretionary assignment.

While traditional consultants have many of the desirable skill sets of a fiduciary partner including familiarity with client objectives, policies and operating constructs, and have experience in conducting asset allocation studies and manager due diligence, they have less experience in managing portfolios on a discretionary basis. To address the issue, some providers have added professionals with investment management experience in a cautious commitment of resources to the OCIO service offering. An important part of any due diligence of a potential fiduciary partner will be to evaluate the firm's experience and ability to assemble and retain a highly competent team.

Investment Philosophy and Process

The foundation of a successful partnership inevitably consists of guiding principles that are shared or complementary. In an investment outsourcing engagement, an OCIO provider's investment philosophy needs to be congruent with those of the sponsor to make the fiduciary partnership work smoothly. Consequently, it is important to find a provider that has a clear and well-articulated investment philosophy.

An evaluation of a provider's investment approach and process should exhibit clear evidence of their philosophy throughout. An example could be a bias to invest in value-oriented strategies or a strong discipline around rebalancing. Whatever the case, a thorough due diligence should provide clarity on the consistency of the firm's investment approach. The advisor should be able to demonstrate a process that is well thought out, disciplined and repeatable. Areas of focus in a due diligence should include a review of asset classes utilized and rationale, strategic and tactical asset allocation over time, approach to diversification, portfolio construction, manager due diligence and selection, portfolio turnover and risk measurement and assessment. Of course, no discussion would be complete without an evaluation of resources the advisor brings to bear in executing on its process and strategy. This would include investment and support people, systems and operational protocols.

Risk Management

One of the primary reasons sponsors search for investment outsourcing solutions is to manage and monitor portfolio risks more effectively. Providers are expected to have robust and sophisticated management tools and processes in place. A due diligence should be designed to reveal how a provider defines, measures and manages risk. For example, which specific risk factors are monitored and how are they measured, which tools are used, what processes and protocols are in place to manage risk and understanding who is involved. Discussions should also be supplemented with practical examples and a demonstration of the firm's processes and systems.

Infrastructure

Outsourced providers that have well thought out and established infrastructure ensure that the day-to-day management of portfolios are handled in a well-controlled manner. This reduces operating and business risks of all sorts. A due diligence should include a review of front and back office operations and processing, operating capacity, trading and regulatory compliance, recordkeeping, communication systems, protocols and contingency plans. Discussions should also include a review of how the client relationship would be onboarded upon commencement of the engagement and how communication would work going forward.

Reporting

Aside from meeting performance expectations over time, relationship management and client service are important in ensuring a strong working partnership. Traditional investment consultants should be well positioned to provide a superior service model having a great deal of experience in servicing clients already, albeit on a non-discretionary basis. Under a discretionary engagement, there is expected to be at least monthly flash reporting and more in-depth quarterly reporting of performance and portfolio management activity. Reporting should be sufficiently clear to allow client committees and boards to have good oversight. The OCIO would also be expected to assist client staff with tasks as varied as managing cash flows, providing information for internal reporting and annual audit requirements.

Current Market Trends

There are a number of notable trends prevalent in the OCIO market today:

- Consolidation among OCIO providers to achieve size, scale and better market position
- OCIO fees have drifted lower amid competition
- An increase in OCIO replacement searches
- An increase in requests for an independent professional evaluation of an existing OCIO provider to demonstrate fiduciary oversight and ensure services received are adequate and competitive.

Conclusions

Asset owners and investment program sponsors have a great deal to consider in ensuring the achievement of their mission, goals and objectives over time. The investment landscape has become more global and complex in nature. Many fiduciaries recognize the need to keep properly diversified portfolios, including expanding the investment opportunity set, adding uncorrelated and higher return generating strategies, and employing hedges. The broad array of strategies and fund offerings available in the market today requires strong investment skills and judgment to ensure successful implementation in portfolios. Many sponsors concede that they need assistance, and access to alternative investment strategies to improve the prospects of achieving their objectives.

The decision to outsource investment discretion is an important one, which necessitates a thoughtful and systematic approach in selecting the right OCIO provider. While outsourcing investment discretion is appealing for many institutions with limited resources, fiduciary responsibilities remain with the sponsor needing to implement consistent and effective oversight of the program and OCIO provider. For those that decide to pursue investment outsourcing, finding the right fiduciary partner will require that the OCIO provider have a solid combination of investment capabilities, resources, client service skills and commitment to transparency. Establishing clear expectations and concrete metrics to measure success are also important.

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