

Outsourced Investment Management: An Overview for Institutional Decision-Makers

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Authors

John S. Griswold, Executive Director
Commonfund Institute
jgriswol@cfund.org

William F. Jarvis, Managing Director
Commonfund Institute
wjarvis@cfund.org

15 Old Danbury Road
Wilton, CT 06897

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Outsourced Investment Management: An Overview for Institutional Decision-Makers

Once seen primarily as a solution for small institutions with limited resources, outsourcing of the investment management function is now widespread, with a broad range of long-term investors turning to the outsourced chief investment officer model. Properly implemented, outsourcing can help institutions with both large and small asset pools to address portfolio complexity and risk management challenges, benefit from more timely decision-making and contend with an increasingly rigorous regulatory environment, while enabling trustees to focus on improving institutional governance.

Definition and Rationale

Definition

Among institutional investors with long-term portfolios, the practice of delegating a significant portion of the investment office function to a third-party provider, typically an investment management or consulting firm, has increased steadily over the past decade. Outsourcing, as it is broadly known (the terms “outsourced chief investment officer” or “OCIO” are also used), encompasses a wide range of models, depending on the degree to which the institution commits itself to delegation of investment discretion and the operational methodology

it employs in carrying out its decision. Smaller institutions may benefit from a set of efficient and standardized portfolio choices, while for mid-sized and larger investment pools the outsourcing provider designs a customized solution for the institution based on its risk tolerance, return targets and other requirements. Such a comprehensive approach includes investment policy review and counsel as well as implementation via portfolio construction and asset allocation, manager due diligence and ongoing monitoring, portfolio rebalancing, risk management and reporting. The provider thus assumes responsibility for the institution’s entire investment process, filling a role equivalent to that occupied, at institutions with very large investment pools, by the internal investment office staff.

As a legal matter, the extent to which investment discretion is delegated by the institution’s board of trustees to the outsourcing provider depends upon the model selected and the preferences, needs and capabilities of the trustees, the investment committee and the OCIO provider. Some institutions may prefer that the investment committee and staff retain hands-on control, remaining involved in all investment decisions. Other institutions and committees may find it best to delegate essentially the entire investment function to the OCIO provider, retaining approval of only the highest-level portfolio policies such as the setting of strategic asset allocation targets.

Rationale

The OCIO model was developed in response to profound changes in the institutional investment environment over the last decade, which have placed increasing pressure on the traditional nonprofit governance model. While some investment pools still consist of a traditional mix of stocks, bonds and cash, many institutions have sought to increase investment return and decrease portfolio volatility through more highly-diversified asset allocation strategies. Use of alternative investments has grown, demanding much closer analysis, due diligence and ongoing monitoring. Volunteer boards and investment committees, meeting only four or five times a year, have been challenged to construct and monitor these complex portfolios, which have become the standard for many long-term investors. New legal and regulatory requirements, too, have placed a heavier load on fiduciaries. Taken as a whole, the investment process is far more time- and resource-intensive than ever before.

Quantitative and qualitative resource improvements.

Independent surveys¹ of the investment management and governance practices of educational endowments, foundations and operating charities have confirmed that institutional staffing levels have not, on average, kept pace with the rapidly evolving demands being placed on institutions:

- The average number of full-time equivalent (FTE) employees devoted to the investment function has remained stable at between 1.3 to 1.6 FTEs. At many institutions, less than one FTE is responsible for investment management, with the remaining time being divided among multiple areas of responsibility.
- The average number of investment committee members is between six and eight. However, only around half of investment committee members are investment professionals; the rest, by implication, are mission-related staff or lay people.

This lack of internal investment professionals has supported the adoption of outsourcing. Rather than face the difficult and expensive task of recruiting, compensating and managing internal staff, institutions that have chosen to outsource have viewed the decision as a way to acquire staff with a level of expertise that they would otherwise be unable to obtain. Because of the flexibility of the OCIO model, institutions can choose how much or how little they want to outsource, ranging from the entire portfolio to a specific allocation or strategy.

¹ The NACUBO-Commonfund Study of Endowments* and the Commonfund Benchmarks Studies* of Foundations, Operating Charities and Healthcare Organizations.

Governance Metrics for Nonprofit Organizations

Average Number	Colleges and Universities	Private Foundations	Operating Charities
Total Institutions	831	140	63
Full-time equivalent staff devoted to the investment function	1.6	1.4	1.4
Voting members on investment committee	8.0	5.4	8.1
Investment committee members who are investment professionals	4.2	2.5	5.0

*For colleges and universities the fiscal year end shown is June 30, 2012. For other nonprofits, the fiscal year end is December 31, 2012.

Source: NACUBO-Commonfund Study of Endowments, Council on Foundations-Commonfund Study of Investments for Private Foundations and Commonfund Benchmarks Study of Operating Charities.

Stronger infrastructure.

In the wake of the global economic crisis, which left many institutional investors with declines of 20 percent or more in the value of their assets—losses from which some have not yet fully recovered – institutional infrastructure has moved to the forefront as a primary discipline alongside return generation. In addition to bolstering internal staff expertise, an outsourced CIO provider can supply the client institution with substantial investment and operational infrastructure for far less than it would cost to build in-house. These resources can be particularly advantageous for a foundation or endowment with a small- to mid-sized asset pool, where the staff, however knowledgeable, may lack the time or expertise to perform multiple tasks well. A robust operational, legal, accounting and risk management platform provided by the OCIO firm can furnish the client institution with resources equivalent to those of a much larger investment office.

Such a structure can also offer the more general benefit of an improved information network. An outsourcing provider's position within the industry may provide greater insight into a particular portfolio manager or strategy than an in-house CIO or investment team would possess, and the outsourced CIO may have valuable connections to industry information via proprietary and third-party research and relationships with other industry professionals.

Improved time allocation and more efficient decision-making.

As investment management practice has become more demanding, awareness of governance requirements and fiduciary responsibilities has also increased. The traditional practice of devoting the bulk of board or investment committee meetings to relatively short-term decisions such as the hiring and firing of managers is in opposition to the thoughtfulness required for

discussions related to investment strategy, portfolio optimization and monitoring, policy-making and governance. To the extent that outsourcing enables fiduciaries to allocate their time more appropriately to these important issues, it has the potential to allow them to fulfill their fiduciary responsibilities better.

Institutions supported by an outsourced investment office may also be able to make decisions in a more timely fashion than those relying on the traditional model of an investment committee with a quarterly meeting schedule. Recent research seems to support this idea. A 2011 survey conducted by Mercer LLC² of decision-making processes at 100 long-term investment pools belonging to both corporate and non-profit institutions (primarily defined benefit and defined contribution plans, endowments and foundations) found that a major concern among respondents was the desire for decisions to be made faster and with greater sophistication in volatile, fast-moving markets. Twenty-seven percent of participating institutions said that their boards or investment committees had missed investment opportunities because of the time it took to make or implement investment decisions. The most significant factors leading to those delays were market volatility (26 percent) and a lack of expertise (23 percent). Delays in execution of asset allocation or manager changes were attributed primarily to insufficient staff (18 percent), market volatility (15 percent) and lack of time for the board or committee to meet (14 percent).

The time required to make a decision also varied. Thirty-five percent of survey respondents said that it took more than three months to make a decision on asset allocation or manager changes, with 12 percent reporting that it took between six months and one year. Once the decision was made, 44 percent of respondents said that they took a further one to three months to execute it, while 22 percent took more than three months to implement a decision.

The advantages of outsourced resources in these situations are readily apparent. For example, an OCIO with discretionary authority may be able to terminate a manager upon the occurrence of an adverse event such as the departure of a key employee and replace it with another while maintaining continuous investment of the assets. A traditional investment committee, in contrast, may wait several months until its next scheduled meeting before taking action. Part of the benefit of the OCIO model for institutions like these may thus lie in the delegation to the outsourcing provider of the power to make decisions expeditiously.

² Mercer LLC, "Investment Decision-Making Survey" (March 2012). <http://www.mercer.com/articles/us-investment-decision-making-survey-2012>.

Growth of Outsourcing

The outsourced CIO model generally began as a service for institutions with smaller endowments, but in recent years larger institutions have begun to consider investment outsourcing. As outsourcing becomes increasingly common, more investment committees are considering whether the model might be applicable to their own situation. Studies have shown that around one-third of non-profit institutions have substantially outsourced management of their portfolio:

Outsourcing by Nonprofit Organizations*

Numbers in percent (%)	Colleges and Universities	Private Foundations	Operating Charities
Total Institutions	831	140	63
Have substantially outsourced the investment function	38	38	30

*For colleges and universities the fiscal year end shown is June 30, 2012. For other nonprofits, the fiscal year end is December 31, 2012.

Source: NACUBO-Commonfund Study of Endowments, Council on Foundations-Commonfund Study of Investments for Private Foundations and Commonfund Benchmarks Study of Operating Charities.

Deciding on an Outsourcing Program

An institution's decision to work with an OCIO provider will likely depend on several factors:

- **Degree of Discretion:** What role do the institution's board and investment committee want an outsourced provider to play, and how do they expect that provider to interact with them, the staff and any other constituents?
- **Proper Oversight:** To what extent is the institution's existing investment policy statement an effective governing document for its financial resources and mission?
- **Achievement of Objectives:** How confident is the institution, given its investment objectives and risk tolerances, in the future performance of its existing portfolio managers and strategies?

A key determinant of the success of an organization's OCIO model is defining the respective roles and responsibilities of the institution's board, staff, investment committee and the outsourced CIO. Investment committees should think carefully about the institution's ultimate objectives in order to articulate objectives that are understandable and clear.

Although the outsourcing trend began with institutions that delegated essentially all their investment function to providers, at this point the model is quite flexible and able to accommodate almost any level of discretion desired by institutions along the spectrum from minimal to total outsourcing. A number of factors determine which model will work best for a particular organization, including the governance structure of the institution, the makeup of the investment committee, the number and expertise of existing internal staff, and the committee's considerations of how it wishes to spend its time. For some institutions, granting full investment discretion to a third party may be seen as an overdue and welcome step. For others, the investment committee and staff may wish to delegate only certain functions – for example, conducting capital calls or rebalancing the portfolio mix – while retaining their current level of engagement in the design, management and oversight of specific strategies.

The following factors will influence the way in which institutions consider the decision of whether, and in what manner, to outsource:

Discretion.

The degree of discretion retained by the institution is a critical issue, because it largely determines which OCIO model will be employed. For example, in increasing order of detail, is the investment committee willing to delegate:

- Policy-level decisions that encompass asset allocation?
- Implementation decisions that determine which strategies to choose?
- Manager-level decisions on who will select managers?
- Security-level decisions to determine who will make actual purchase selections?

If the institution chooses a total outsourcing approach, the investment committee will typically establish an overarching investment framework, embodied in an investment policy statement and other supporting documents, and then turn over full implementation —manager selection, strategy selection and similar decisions—to the provider.

A less comprehensive model involves a hybrid consultant/OCIO approach, where the committee desires to retain asset allocation decisions but feels it does not have the time to get involved in manager selection and strategy selection. Here, a third party (which may be an investment consulting firm or the OCIO provider itself) assists in preparing the investment policy statement and guiding the committee to a policy asset

allocation decision. The OCIO firm then implements the investment policy on a discretionary basis, using the policy asset allocation as a guide and reporting on a regular basis to the committee.

Expertise.

The issue of control is closely related to that of the committee's expertise. Institutions that lack investment expertise may feel more comfort – or, indeed, relief – at delegating most or all financial decision-making to the OCIO provider. On the other hand, institutions with substantial expertise on their committees may prefer to begin with a less-comprehensive relationship, handing over discretion incrementally as they grow more comfortable with the OCIO model.

Size of Investment Pool.

As we have seen, organizations possessing smaller investment pools have generally been the first to adopt outsourcing. Being comparatively resource-poor, they stand to obtain the greatest relative benefit from the presence of an independent and active OCIO fiduciary and from potential access to better-performing managers. For these organizations, a high degree of customization is not cost-efficient; a relatively standardized set of portfolio choices, implemented by an experienced manager at a reasonable cost, is in many cases the optimal solution. For organizations with larger investment pools, the benefits of customization within the OCIO structure can yield clear benefits in the form of both additional diversification and advice on how to align the organization's investment policy and asset allocation decisions with its mission and investment goals.

Communications.

The frequency, level of detail, technical support and form of delivery of communications are all key factors in a successful OCIO relationship. Different institutions' preferred communication strategies vary. Some may require formal committee or board presentations to cover policy-level discussions, performance reviews, portfolio updates and market or economic points of view from the OCIO. Others will be satisfied with less-formal analyses of matters such as spending policy, liquidity needs and cash reserves.

The frequency of these communications will depend on client preferences. Generally, institutions that have chosen a more fully-outsourced CIO model prefer quarterly or semi-annual reports, while those that have retained greater control tend to require more significant and frequent contacts. In both situations, the OCIO provider is expected to notify the client when an important issue arises.

Fees

Fees for outsourced management are calculated in addition to investment management fees. According to a recent study, the outsourcing provider “typically charges a fee as a percent of AUM that ranges from 30-100 basis points” [i.e., between 0.3 – 1.0 percent of assets under management],³ but some managers charge only the investment management fee and receive no fee for the outsourcing service as such. Some providers may charge an incentive fee in addition to their base fee, and for specific mandates—alternative strategies, for instance—some may charge a premium.

Conclusion

Outsourcing of investment management is a growing trend among institutional investors. With a broad range of institutions using or exploring the OCIO model, portfolio size is no longer the determining factor driving the outsourcing decision. For all but the largest—those with deep staff and technology resources as well as wide-ranging investment expertise—outsourcing is increasingly an option meriting serious consideration.

Institutions that decide to outsource are basing their decision on the desire to:

- Optimize management and oversight of increasingly complex investment portfolios
- Enable timely decision-making
- Make more efficient use of limited staff resources
- Allow trustees to better fulfill their fiduciary duties by focusing on policy and strategic oversight
- Deal with a more rigorous regulatory environment

The OCIO concept offers a broad range of implementation models, enabling different types and sizes of organizations to identify a model that works well for their particular needs and preferences. As institutions face the twin challenges of portfolio complexity and resource scarcity, the OCIO model seems likely to grow in popularity among long-term investors.

Some questions to Ask an Outsourced CIO Candidate

- What is your process for determining an institution’s asset allocation?
- How do you evaluate managers? What criteria govern your decision to dismiss or change a manager?
- How frequently do you make strategic portfolio changes? Can you implement tactical adjustments to take advantage of market opportunities?
- How many of your current clients are similar to our institution in size, mission and investment goals?

³ R.V. Kuhns & Associates, Inc., “Considering the OCIO Option: Not an Everyday Decision for Fiduciaries”, Feb. 2013. <http://www.iiforums.com/cfr/presentations/cfr13-ocio.pdf>.

About the Authors



John S. Griswold

John S. Griswold is Executive Director of Commonfund Institute (see “About Commonfund Institute”). John joined Commonfund in 1992 as head of Client Services and subsequently initiated and supervised the Commonfund Benchmark Studies®, annual surveys of the investment performance and governance practices of educational endowments, foundations, operating charities and nonprofit healthcare organizations. More recently, he led the Institute in joining with the National Association of College and University Business Officers (NACUBO) to produce the NACUBO-Commonfund Study of Endowments® (“NCSE”). He supervises and speaks at Commonfund’s annual Endowment Institute and Commonfund Forum as well as at monthly Trustee Roundtables and nonprofit investor conferences in the U.S., Canada and Europe. A member of numerous nonprofit boards of trustees, he is a graduate of Yale University.



William F. Jarvis

William F. Jarvis is Managing Director of Commonfund Institute, responsible for the Institute’s research, written analysis and client publications. A financial services executive and attorney, Bill has worked with J.P. Morgan, where he spent 13 years as an investment banker in New York and Tokyo; Greenwich Associates, where he advised leading investment management firms and led the fielding of the first Commonfund Benchmarks Study®; and Davis Polk & Wardwell, where he provided legal advice to global banks and securities firms. Prior to joining Commonfund in 2006, he served as Chief Operating Officer of a privately-held hedge fund manager based in New York City. Bill holds a BA in English literature from Yale University, a JD from the Northwestern University School of Law and an MBA from Northwestern’s Kellogg Graduate School of Management.

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