

Choosing an Outsourced Chief Investment Officer (OCIO)

Goldman Sachs Institutional Client Solutions

Introduction

In this Goldman Sachs Institutional Client Solutions white paper, we explore the issues boards and investment committees should consider when evaluating an OCIO model.

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Current Trend Towards an OCIO

The United States is fortunate to have both a long-standing tradition as well as a current culture of giving. As a result, there are numerous charitable organizations with sizable investment portfolios. However, with these portfolios comes the responsibility of financial stewardship. While the use of a volunteer investment committee to directly manage the portfolio has been a common historical practice, many charitable organizations are revisiting this approach.

Organizations are evaluating the outsourced chief investment officer (OCIO) model as an alternative route. In this model, while the charitable organizations' investment committees retain governance oversight of the portfolio, they outsource many investment decisions and operational responsibilities to an outside advisor.

Historically, the challenge of managing an endowment portfolio was much simpler for an internal investment committee. In the 1950s and 1960s, the typical portfolio would have likely consisted of large cap equities and investment grade bonds picked by the investment committee. International equities would have been considered exotic.

Today's investment committees face a far more complicated world. The current investment landscape includes international developed equity, below investment grade bonds, emerging markets equities and local debt, commodities, and illiquid asset classes such as hedge funds and private equity as standard asset classes. This complexity is one of the catalysts behind the trend of small and mid-size charitable organizations adopting the OCIO model.

Present-day market environments also require nimble implementation of investment views. An investment committee which meets quarterly may not act quickly enough to benefit from short- to medium-term imbalances in the market. An OCIO model can allow organizations to take advantage of these potential investment opportunities in a timely manner.

Growth of the OCIO market

According to *Pensions & Investments*, the size of the OCIO market has grown significantly over the past few years and now stands at more than \$2.66 trillion.¹

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The greater complexity of the financial markets, and resulting investment opportunities and vehicles, requires increased levels of expertise and due diligence from investors. Small to mid-size organizations, often thinly staffed and leanly run, tend to not have the resources to hire investment specialists. The investment responsibilities will typically fall to the CFO, who is already juggling many other responsibilities simultaneously. In contrast, universities with multi-billion-dollar endowments can afford to spend and build out large and substantive investment staffs.

Recognizing the already heavy workload carried by their staffs, many charitable organizations seek the needed investment expertise by carefully recruiting and selecting investment professionals to their investment committee. An informed investment committee, well-versed in investment issues, can be extremely valuable and additive to the investment process. However, as a complete solution, it has a number of pitfalls.

Economics of the OCIO: Rent vs. Buy Decision

A common question that businesses face is whether to outsource or insource an organizational function (“Rent” vs. “Buy”). Key drivers of the ultimate decision are whether the function is a core competency and whether the organization has the resources and scale to support the function. Charitable organizations with large multi-billion-dollar endowments can “buy” their investment expertise by hiring an internal CIO with an accompanying investment team. Their size allows them to do this, as the costs are amortized over billions of dollars of assets. In contrast, small and mid-size organizations have less scale. “Buying” investment expertise in-house with the associated fixed costs would be prohibitively expensive given their smaller asset base. These economics make the OCIO model attractive to organizations with more modestly-sized portfolios as it allows them to essentially “rent” the expertise rather than “buy” it.

¹ Palash Ghosh, “Volatile markets, growing complexity underscore demand for OCIO,” *Pensions & Investments*, July 2022.

First, an investment committee of volunteers will have a different level of accountability than a paid professional. The potential for termination tends to heighten one's focus! Second, the recruited investment professionals may sometimes be extremely specialized and lack the broader asset allocation and portfolio construction skills applicable to a broadly diversified portfolio. Occasionally, these specialized professionals may even bring a bias towards their own asset class. For instance, successful hedge fund managers may, due to their familiarity with their own asset class, steer the portfolio towards an overweight in hedge funds. Finally, there is also the question of who performs the due diligence on investment ideas raised by the investment committee (e.g., investment manager selection or operational due diligence on an alternative investment).

While the increased complexity of markets has been a long-term driver of the trend towards the OCIO model, the 2008–09 financial crisis has been a more recent driver. The crisis significantly strained the foundations and endowments of most charitable organizations and, as a result, many began to explore the advantages and disadvantages of the OCIO model.

Important Functions of an OCIO

A capable OCIO should be helpful across a wide range of investment functions, including strategic asset allocation, tactical asset allocation, portfolio construction and implementation, education and reporting.

Strategic Asset Allocation

The OCIO should gain a solid understanding of an organization's investment objectives, constraints and operating environment. With this knowledge, the OCIO can help guide the organization to an appropriate strategic asset allocation based upon the organization's specific circumstances. The OCIO should be able to make a customized recommendation that properly takes into account the organization's investment objectives, time horizon, risk tolerance and liquidity needs. This is an iterative process for the OCIO and the organization, as they seek to balance the trade-offs of various allocations.

A particularly helpful metric that the OCIO should share is a measure of the strategic asset allocation's downside risk. This might be expressed as the likely return in a one-in-a-hundred-year flood scenario or simply how the allocation would have fared during the 2008–09 financial crisis or the inflation spike in the early 1970s. It is important for an investment committee to assess whether the organization could withstand such a shock and whether the committee would have "staying power" in such scenarios. Tailoring the strategic asset allocation's downside risk to the organization and the investment committee's risk tolerance is one of the most crucial tasks that the OCIO and the investment committee undertake.

An organization may also have multiple investment pools with different objectives and time horizons for each pool of assets. In this case, the OCIO should make multiple recommendations—not take a one-size-fits-all approach. For instance, the allocation for assets earmarked for a short-term construction project should have a significantly different asset allocation than the assets in the long-term endowment. Each investment pool's long-term strategic asset allocation should reflect these differences.

Tactical Asset Allocation

A common challenge facing an investment committee is how to be nimble with respect to market dislocations and potential opportunities. Committee decision making is often slow due to quarterly meeting cycles, the difficulty of scheduling intra-quarterly ad-hoc meetings, and the desire for broad consensus. As a result, many potential opportunities are missed. Under the OCIO model, an investment committee can delegate the tactical asset allocation responsibility to the OCIO. The OCIO will look for potential tactical opportunities, implement them and report back to the committee in a timely manner. However, such delegation by the committee should not be made without guardrails. Boundaries on the level of delegation are typically laid out in an account agreement.

Portfolio Construction and Implementation

The OCIO can select and monitor investment managers (active or passive) for each specific asset class. The monitoring should include surveillance for potential style drift and changes in the investment manager's key decision makers. The OCIO needs to size the allocations to each manager appropriately, track the risk of the overall portfolio and rebalance accordingly. All of the operational issues surrounding this implementation process should be the responsibility of the OCIO, thus lightening the day-to-day burden of the organization's staff.

Organizations should carefully consider the OCIO's external manager selection capabilities given the extensive resources required. The due diligence process should include an evaluation of a manager's investment strategy, portfolio and performance analysis, and risk management assessment. From an operational standpoint, the OCIO should perform background and reference checks, onsite manager visits, analysis of back-office accounting, finance, technology and human resources operations, and review of fund documents.

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Reporting and Education

The OCIO should also provide appropriate reporting and performance attribution analysis of the portfolio's returns. The performance analysis should provide the investment committee with an analytical explanation of how the returns were generated. For example, which decisions were contributors and which decisions were detractors from the returns? This type of analysis is useful for a committee to understand the portfolio's key risks and return drivers and can help prioritize the committee's discussions.

Finally, a well-resourced OCIO may also offer a range of educational opportunities to the staff and board members. Relevant topics might include investing fundamentals, trends amongst charitable organizations, sustainable and responsible investing, and legal and regulatory developments.

Impact of an OCIO on Committee Dynamics

A desire for consensus and the potential for group think can both impact the decisions made by an investment committee. While the use of an OCIO will not eliminate all decision-making biases, it can mitigate their impact in certain cases. Some investment committees seek consensus around decisions, likely driven by a desire for harmony or the reluctance of individual members to raise controversial opinions. This tendency slows decision making and potential tactical portfolio adjustments are often tabled for future discussions that may occur too late or sometimes never at all. By delegating tactical asset allocation decisions to an OCIO (within the parameters of the strategic asset allocation’s permissible ranges), the organization can have a much more dynamic investment process.

OCIO Investment Functions

A capable OCIO should be helpful across a wide range of investment functions. Boards and investment committees should carefully evaluate an OCIO’s depth of resources and ability to provide comprehensive, one-stop investment program support.



A seasoned OCIO with a robust investment process can also help temper potentially emotional decisions brought on by group think and the tendency for people to incorrectly over-extrapolate current events into the future. At the height of the dot-com bubble in 2000, with the media reporting the latest technology IPOs and reinforcing the message of

“Stocks for the Long Run,” investors felt very comfortable with investing heavily in stocks. In contrast, ten years later in the spring of 2009, investors were tempted to sell stocks and move to cash as talk of a worldwide recession dominated media coverage. An experienced OCIO leading an investment process rooted in valuations and long-term data would have helped add perspective during these extreme markets conditions. In addition, a process with a focus on downside risk management can inform an investment committee of the potential pitfalls of a higher volatility portfolio.

Working with an OCIO

A successful adoption of an OCIO model requires a very clear understanding of the roles and responsibilities of the OCIO and the organization’s board of directors, investment committee and staff. The lack of such an understanding can lead to confusion and a sub-optimal implementation of the OCIO model. In a traditional view of these roles, the investment committee acts as a governing fiduciary and the OCIO acts as the managing fiduciary. While both are fiduciaries, the roles are quite distinct.

While the OCIO can make recommendations regarding the organization’s investment policy statement and strategic asset allocation, the investment committee ultimately approves these recommendations. With respect to day-to-day investment decisions such as tactical asset allocation, portfolio construction, manager selection and termination and rebalancing, the investment committee would delegate these decisions to the OCIO. The latitude of the OCIO with respect to these day-to-day management decisions would be subject to any constraints laid out in an account agreement.

Advantages and Considerations of the OCIO Model

| Advantages | Considerations |
|--|--|
| Professionalism / expertise | Cede some operational control (not oversight) |
| Depth of resources | Additional fees with some potential for claw back via the buying power of OCIO |
| Access to a full range of investment opportunities | Requires more proactive board education |
| Serve as an extension of the organization’s staff | Risk of selecting a poor OCIO |
| Nimble and dynamic rebalancing | |
| Investment Committee can focus on larger, strategic issues | |

The key advantage of the OCIO model is that it allows a small to mid-size organization that lacks the resources to build out its own investment expertise to access the expertise and resources of an experienced advisor—the OCIO. This access can enhance the organization’s investment process and will likely broaden the range of investment opportunities

open to it. The outsourced solution's streamlined decision-making process enables nimble and dynamic rebalancing, enhancing the organization's ability to exploit market imbalances. The OCIO model will also ease the burden on the organization's staff and allow the investment committee to focus on important, high-level strategic decisions.

The organization will cede some operational control for day-to-day investment decisions. However, a clear account agreement will limit the discretion of the OCIO and the investment committee will always retain oversight responsibility. While there may be additional fees associated with using an OCIO, organizations could benefit from the OCIO's buying power and ability to negotiate manager costs. In some cases, the migration to an OCIO model may require proactive education for some board members as it can represent a cultural change.

Summary

As the trend towards using an OCIO continues to grow, it is important for boards and investment committees to evaluate the OCIO model based on their organization's specific goals and needs. Given the wide range of OCIO providers in the marketplace, organizations should pay close attention to the OCIO's service offerings, breadth of resources, investment options, risk management capabilities, and experience with portfolio outsourcing. An OCIO with extensive experience can bring thoughtful portfolio solutions tailored to each client's unique needs.

About the author

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