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Sound Thinking

IAN TONER, CFA

Four rules of outsourcing

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The choice to use the services of an Outsourced Chief Investment Officer (OCIO) provider is one of the most significant decisions that a board is likely to make.

There are plenty of technical papers available within the industry today that address the decision-making process[1]. This piece, however, is focused on the four most important rules that Verus believes investors should understand, and OCIO providers should deliver upon.

Rule one: Good governance is a good investment.

Outsourcing is a governance decision before it is an investment decision. Making sure that the governance structures are correctly aligned is vital to the success of any partnership with an Outsourced CIO.

This rule begins by recognizing what an investor actually puts in motion when they outsource: they are changing the place where certain decisions reside, delegating the responsibility for those decisions to the OCIO provider, and adopting for themselves a new, more governance and oversight focused, role. This is quite different from the relationship that applies to a more traditional consulting structure, where the advisor advises, but where all decisions are eventually made by the investor board.

WHY IS THIS SO IMPORTANT?

First, it draws attention to the fact that the board is performing a different role in an OCIO relationship, a role that has changed from ***decision-making*** to ***governance***. For the board, the governance role means paying attention to new things while focusing less on others, asking questions about the OCIO provider's process and monitoring outcomes, rather than focusing and weighing in on each underlying investment decision.

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1. *Including work from Verus, both in the past and upcoming, of course.*

In practice this means that the board should spend time on making sure that the OCIO provider is clearly articulating a coherent process and philosophy, and that this process and philosophy are applied to the actual decisions that are being made. Manager and product selection decisions will generally be delegated to the OCIO provider; that means that the board needs to change focus from which manager they would have picked themselves, to the reasoning behind why the OCIO provider picked the combination of products that they did. For example, if a decision were made to reallocate a portfolio from one core bond manager to another, instead of focusing on why a different investment manager would have been a better fit than the one chosen, they could spend time instead on understanding why the overall reallocation was made and what the long-term outcome is for the portfolio that the OCIO provider is seeking to influence.

This change can be difficult for boards to manage. When an OCIO provider comes on board, every single manager and product in the portfolio is one that the board members picked themselves, involving people they know and products whose success they are vested in. The OCIO provider may look to change some, or all of these managers to deliver whatever outcomes are needed. It may be very difficult for a board to sit passively while these changes to the portfolio are happening. But good governance suggests that boards should not be tempted to influence these investment decisions, and to focus instead on the decision-making process and making certain that the OCIO provider is behaving in a prudential and appropriate fashion. After all, the purpose of hiring an OCIO provider is to put the investment decision-making process into the hands of a fiduciary who is focused solely on portfolio management, whose craft is asset allocation investing, and who is vested in the success of the portfolio over time.

Second, the board's concerns can shift significantly. Rather than dwelling on administrative details, for example, the board can redirect its attention to the metrics and reports that are most likely to affect long-term outcomes. The shift in focus will turn more to the total risk level of the fund and longer-term management issues, rather than countless meetings reviewing potential investments and receiving education on nuanced decisions that perhaps contribute little to the overall health of the portfolio. It is reasonable for the board to choose specific decisions that the OCIO provider has made, and to spend time working through those decisions with the provider in detail, to gain insight into the decision process that is being used, to make sure that it is in line with expectations and that it meets fiduciary requirements – but it is vital during those conversations that everyone involved understands that the focus is on the process not each underlying investment decision.

Third, the board can begin to focus on some of the broader, and often more pressing issues that are under their purview, which are not delegated to the OCIO provider. There are a range of policy questions that feed into the broader Investment Policy Statement relating to funding status or fund raising, the role of ESG or SRI, and so on. These are decisions that cannot easily be delegated by the board. The time that otherwise would have been spent on the functional elements of running the portfolio can now be devoted to these topics.

The single most important change from non-discretionary to OCIO is clearly the change in governance:

who is making the decisions rather than what decisions are being made[2]. Getting this right is the first rule of successful outsourcing.

Rule two: Cookie-cutter solutions may not cut it for you.

Every portfolio should be different — because every investor is different. Making sure that there is an appropriate level of customization to reflect these differences is vital for an effective outsourced relationship.

This rule is designed to push back on the tyranny of standardization that will naturally infect portfolio construction. OCIO providers will always have a natural desire to create standardized solutions: a positive interpretation of this is that the standard solution represents the provider's best ideas, while a more cynical interpretation is that the economic interests of the OCIO provider are likely to align with more standardization. Standardization will help the client, inasmuch as the portfolio constructed does, in fact, represent the best ideas of the provider[3], but will potentially hurt if the standard portfolio fails to meet their specific needs exactly.

There are two things to focus on: the degree of standardized (and, in particular, proprietary) product used in the portfolio, and the type of interaction expected between the client-facing team and the investor. With regards to the first area of focus mentioned above, while some product standardization clearly makes sense, it is extremely important for an OCIO provider to maintain enough flexibility in implementation to account for the needs of the specific investor. This might relate to liquidity sensitivity, turnover sensitivity, particular ESG or ethical issues, or sensitivity to downside events. That can be hard to do in a large-platform environment where most of the needs of the client are expected to be met by proprietary products, even if those products are multi-manager structured. Investors should be particularly skeptical about proprietary products: not so much as to refuse their use, but enough so that detailed questions are asked about why they were chosen and what governance is in place. The key question that an investor should ask is simple: *How are my particular, unique needs being met by this standardized portfolio solution*?

The second focus then needs to be on who will become the primary investor contact at the OCIO provider. There are two typical types of people in this role: the first is the "client service" person who is highly effective at the relationship management components of the role, but not at heart an investment person, and not someone who is seeking to directly add value with their investment insight. The second type is the "investor" person, often a senior investment consultant with many years of experience giving investment advice and constructing institutional portfolios. The latter approach, in our view, is vital for the success of this type of relationship. They are able to work with the client at every stage of the process and can help immediately with complex and sophisticated problems. With an "investor" acting as the primary investor contact, the previous question (about customization) is unlikely to cause an issue. The primary investor contact will have the experience necessary to roll up

2. *Although often there will be differences between the pre-discretion and the post-discretion portfolio there will be circumstances where there is little change, at least immediately, because the portfolio happens to be structured in a way that the OCIO portfolio manager believes is appropriate to meet the outcomes needed. That should not be taken as a sign that discretionary management was not needed.*
3. *And that those best ideas actually add value. That is not necessarily always true, of course.*

their sleeves at any point in the process. Most important, they can act as the voice of the client throughout the process: not overruling the portfolio manager but making sure that the particular needs of the client are appropriately represented as effectively as possible.

Rule three: Complex portfolios don't mean sophistication.

Complexity is not an end in itself. Any portfolio complexity should be justified based upon the outcomes it is expected to generate. Making sure that every complexity in the portfolio – and the cost of that complexity – is justified and monitored is a core part of delivering effective OCIO outcomes.

There is a good rule of thumb in investing: things that seem too complicated are often bad investments (at least for the buyer). When you decompose the total risk of a complex portfolio into its main risk components, you often find that the resulting exposures look very much like a 60/40 portfolio. Much of the complexity on the surface makes little difference at the total portfolio level, although the higher fees required to access these complex strategies remain.

Undeniably, however, complicated portfolios can look impressive. Companies that sell investment capabilities are unable to make promises about the future results they will deliver, which means their marketing will often focus around their general investment sophistication – and complex portfolios can look like one way of demonstrating that sophistication.

In reality, though, almost the exact opposite is true. Complexity has a real cost in terms of time and resource needed to understand the decisions being made, and likely higher fees. Complicated solutions are often also less liquid solutions, and that illiquidity can cause real problems for investors. Long-lived allocations may tie the investor to the OCIO provider for many years, making it harder to change providers if it is ever needed, and re-emphasizing the importance of governance in the investment process.

Instead, OCIO providers should build the simplest portfolio that they possibly can to achieve the results the investor needs. This will likely involve a notable amount of analysis and work behind the scenes, and the use of some complex products. The OCIO provider should be prepared to justify any such complexities that are embedded in the portfolio and should sufficiently explain the role that such complexity plays and why simpler approaches cannot achieve the desired outcomes.

In our own OCIO practice, this is the approach that we take. Using an array of sophisticated portfolio management and risk tools, the cost of which is scaled via the synergies found in having one centralized team for multiple OCIO portfolios, we focus on studying the risk exposures in the portfolios to understand what sensitivities exist to major risk drivers. We also focus on how to position within each of the major capital markets, and the way that active and passive strategies might interact to drive returns. We are happy to use hedge funds, private markets and other such exposures where they are the best tools to deliver the outcomes the client requires. But where a simple, clear portfolio structure seems like an effective solution to the investment problem the investor faces, we will happily avoid unnecessary complexities.

Rule four: Goldilocks knows - big firm resources with small firm values is just right.

It is true that a certain scale needs to be achieved to provide an effective OCIO service, but the benefits of scale drop off rapidly after a certain point. Making sure that the OCIO provider one chooses is large enough to provide high quality service, yet small enough to be flexible, is a vital element of the hiring decision.

Building institutional quality portfolios is a complex and expensive task, requiring a deep knowledge and understanding of a wide range of investment issues. The provider needs to pull together the big picture, while also responding to changes in conditions quickly where appropriate, and with a clear understanding of the small details that differentiate strategies and approaches. They need to effectively manage the legal and operational issues involved in the process. They need to understand not only traditional investment vehicles but also the complex range of opportunities in both private markets and alternatives. Doing all of these tasks well requires a certain scale of staff. While some smaller providers may be able to provide exceptional personal attention and quality of service, the harsh reality is that a certain amount of scale is needed to make sure that all of the bases are covered. (At a minimum, perhaps a total of 15 people or more involved full time in investment research and portfolio management, although the research staff should be expected to be providing insight to both OCIO and non-discretionary clients of the provider[4].) Fewer than that can create a risk of gaps in the coverage, particularly when there is personnel turnover.

Size is not an unalloyed advantage though. The larger the team gets, the more the pathologies of scale can kick in. Standardization of products and thinking is the only efficient way to run large firms, and as teams get larger, the temptation to create products rather than provide tailored service increases. After a certain point adding more people has little effect on the ability of the firm to identify better manager strategies but may simply result in a larger database of the mediocre – meetings with firms whom otherwise would not get meetings, and follow-ups to make coverage targets, rather than only where necessary. The process gets ungainly too, with communication between key decision-makers getting harder and harder as the number of people around the table grows.

We believe success comes from the investor creating a close partnership with a firm that fits into this happy space – large enough to be effective, but small enough that all of the key decision makers and their team can get around a table to discuss markets, products and their specific portfolios.

Conclusion

The selection of an OCIO provider is a large, complex, and important decision. Focusing on a few key components of this decision can help ensure the choice is made effectively and the investor feels comfortable that interests are aligned, and that the outcome of the selection process is likely to be a good one. These four rules may not be the only ones, but they represent a good start. Above all they

4. *It is important that there is close integration between discretionary and non-discretionary practices at firms which offer both services. It would be bad for different advice or insight to be provided to similar clients with similar needs and risk tolerances simply because the structure of the relationship was different, and an integrated investment team should help avoid that problem.*

represent a call for good governance, for structures aligned with investor needs, for clear and simple investment solutions, and for a focus on the appropriate use of scale. Those are not everything needed for effective OCIO delivery – but it is difficult to imagine truly successful OCIO delivery without them.

ABOUT THE AUTHOR

Mr. Toner has a degree in Law from the University of Oxford in the United Kingdom and is a CFA charter holder (Chartered Financial Analyst). He is a regular author and speaker on a range of investment topics. He is also a member of the CFA Institute and the CFA Society of Seattle. Mr. Toner is a trustee of Charles Wright Academy, an independent co-educational school based in University Place, WA, where he also chairs the endowment committee. He is a member of the Audit / Finance Committee of The Medina Foundation in Seattle. Mr. Toner is also a board member at the Seattle Metropolitan Chamber of Commerce, where he co-chairs the finance & audit committee. He has been happily married to his wife, Heather, for nearly 25 years, and is the proud father of two children.

IAN TONER, CFA
Chief Investment Officer

ABOUT VERUS

Verus is an independent, employee-owned provider of non-discretionary consulting and discretionary management (i.e., OCIO) services to a wide variety of institutional investors, representing over $456 billion in assets*, including endowments and foundations, public pension plans, corporate defined benefit and defined contribution plans, and multi-employer trusts. Verus, renamed from Wurts & Associates in April 2015, has been advising institutional clients since 1986.

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800 Fifth Avenue, Suite 3900
Seattle, Washington 98104
206-622-3700
verusinvestments.com