NAVIGATING THE OCIO LANDSCAPE

KATHRYN E. MAWER, CFA, CAIA
Vice President, OCIO Advisor

GARY R. PRICE
Head of Investment Solutions

F·E·G®
investment advisors

> *"Investment outsourcing remains 'all over the place, (with) different models, pricing schemes, delivery systems and value propositions,' making the task of sifting through it all 'a bit paralyzing.'"*
>
> *– Kevin P. Quirk, Partner with Casey Quirk LLC*

Adoption of the outsourced chief investment officer (OCIO) model has been on an upward trajectory over the last decade. Typically, with increased adoption, comes standardization—although the plethora of models, fee schedules, and value propositions remains confusing, leaving the OCIO landscape difficult to navigate for many asset owners.

The following insights provide an overview of the evolution of the OCIO industry, explore common provider types and models, and discuss the typical client profile for an OCIO relationship. In this analysis, we draw on various industry data sources, research studies, and our own 15 years of experience as an OCIO. We hope this paper will provide clarity as you seek to identify the investment solution that fits best with your organization.

KEY TAKEAWAYS

1) **Defining OCIO**: The outsourced chief investment officer (OCIO) model was bred from the need for both the holistic portfolio perspective of a consultant and the management aspect of an asset manager—offering a total portfolio management solution.

2) **Industry Evolution**: Although early OCIO providers began appearing in the 1970s and 1980s, it was not until after the Great Financial Crisis that the OCIO model became a common alternative to traditional investment consulting. OCIO mandates surged from 2007-2017, bringing current estimates of assets up to $1.1 trillion globally.[1]

3) **OCIO Service Providers**: OCIO providers are often differentiated by their origins and have three common backgrounds. Though each origin has comparative strengths and weaknesses, individual firms must be further assessed to fully understand their profile.

4) **Common OCIO Models**: While many providers claim to offer custom portfolios, the level of customization can vary considerably, with benefits and drawbacks to each approach.

5) **OCIO Client Profile**: Portfolio size often determines which asset owners are most likely to outsource. The adoption of the OCIO model was historically embraced by smaller (under $100 million) institutions, but recently surged in those with mid-size asset pools ($100-$500 million), as mid-sized markets tend to have limited staff.

6) **Differences Between OCIO and Consulting**: The primary distinction between consulting and OCIO services is discretion. In a consulting model, the investor retains discretion on both the strategy and implementation, whereas an OCIO typically has full discretion over implementation but may or may not have discretion on strategy.

1 Cerulli Associates: "OCIO at an Inflection Point: Strong Growth Ahead, but Institutions are Demanding More."

THE OCIO INDUSTRY

DEFINING OCIO

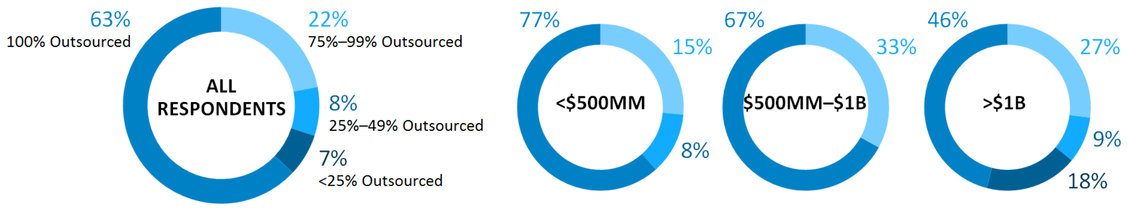
OCIO is often defined as 'total portfolio management,' which harkens back to the original need for a solution to bridge the gap between the two common service models of investment consulting and asset management. Investment consulting is holistic in its vantage point, conveying the 'total portfolio' aspect of the definition, but does not handle the management of assets. Asset management demonstrates the inverse—managing assets in isolation.

For example, traditional consultants not only consider the risks associated with specific asset classes, such as emerging markets, but also how those risks function within the context of the entire portfolio. Conversely, asset managers may be well equipped to both consider and manage the risks within the specific asset classes but are not tasked with taking into account the impact on the total portfolio.

PARTIAL OUTSOURCING

However, this clean definition of OCIO as asset management with a total portfolio perspective is not completely reflective of the current reality revealed by the data. According to the 2019 aiCIO survey, 23% of outsourcing institutions with less than $500 million in assets and 54% of outsourcing institutions with more than $1 billion in assets outsource *only part of their portfolio*.[2] Further, there are many different forms this partial outsourcing can take.

HOW MUCH OF THE PORTFOLIO IS OUTSOURCED



Data source: aiCIO 2019 Outsourced-Chief Investment Officer Survey

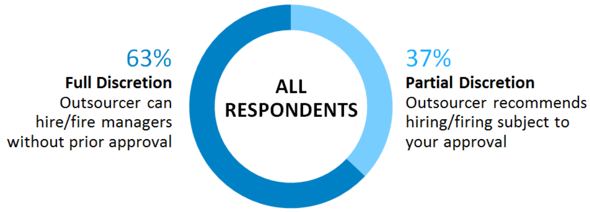
Although partial outsourcing is less common, in our experience, the primary reason clients select this option is because they already possess in-house or committee expertise within some aspect of their portfolio. For example, clients with the capability and resource may elect to manage portions of their portfolio which play best to their strengths—perhaps retaining discretion on the global equities and fixed income manager selection while outsourcing private capital. Thus, in a partial OCIO relationship, the advisor and client agree upon the desired level of discretion on each aspect of the portfolio based on the needs and expertise of the client.

Nuances also arise in the definition of OCIO regarding which specific responsibilities constitute portfolio management. Portfolio management encompasses several functions broadly divided into four steps: (1) setting investment objectives, (2) determining a strategic asset allocation, (3) implementing the strategy, and (4) ongoing management of the portfolio. While each of these steps is critical, accountability for each aspect may lie with the institutional investor, the OCIO, or both.

2 aiCIO 2019 Outsourced-Chief Investment Officer Survey.

One aspect of portfolio management that often oscillates between the investor and the OCIO is discretion over hiring/firing managers—a critical component of step (3), implementing the strategy. According to the 2019 aiCIO survey, 63% of outsourcing firms hire and fire managers on behalf of their clients. The remaining 37% recommend hiring/firing, but the decision must be approved by the client.[3]

TYPES OF OUTSOURCING ARRANGEMENTS USED/PLANNED



Data source: aiCIO 2019 Outsourced-Chief Investment Officer Survey

The areas identified in the survey regarding partial outsourcing and varying definitions of management functions—the so-called "gray areas"—reinforce Kevin Quirk's sentiment that models and delivery mechanisms remain "all over the place."

EVOLUTION

Early OCIO providers began cropping up in the 1970s and 1980s as a solution primarily for smaller market organizations, such as select pension plans, family offices, and nonprofits. During this time, a few firms began offering this service in earnest; however, it was not until after the technology bubble collapse of 2000-2002 and the Great Financial Crisis of 2007-2008 that the OCIO industry experienced rapid growth. These events likely triggered the need for tighter risk controls and more defined governance, both of which can be attained through the outsourced approach.

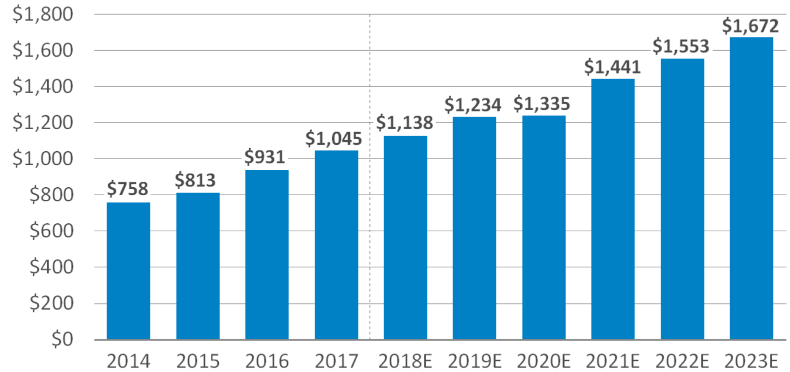
During a 10-year period from 2007-2016, OCIO mandates surged by a 37% compound annual growth rate (CAGR), while revenues increased by a 26% CAGR.[4] This rapid growth attracted a host of both service providers and models—ushering the OCIO model into the mainstream and broadening the appeal of the service to large institutions.

More recently, these elevated growth rates have begun to slow, and the industry has seen an increase in consolidation of OCIO firms and standardization of the OCIO RFP process. These trends suggest that the industry is transitioning from the rapid-growth phase into an early-maturity stage.[5]

Currently, estimated 2018 year-end assets are $1.1 trillion, with projected six-year growth of 8.1%.[6]

3 aiCIO 2019 Outsourced-Chief Investment Officer Survey.
4 2017 Outsource-Chief Investment Officer Buyer's Guide.
5 FEG; Casey Quirk, "The Outsourced CIO Movement," November 14, 2012.
6 Cerulli Associates: "OCIO at an Inflection Point: Strong Growth Ahead, but Institutions are Demanding More."

U.S. OCIO ASSETS UNDER MANAGEMENT, 2014-2023E
$ Billions



Data source: Cerulli Associates

TYPES OF OCIO PROVIDERS

As the OCIO industry moves into early-stage maturity, there has been some standardization in the definitions of types of OCIO providers. Cerulli Associates' 2017 OCIO Benchmarking Study suggests three primary origins of OCIO firms: investment consultant, money management firm/large bank, and boutique/dedicated OCIO.[7]

INVESTMENT CONSULTANT

PROS
– Experience advising clients with total portfolio solutions
– Breadth of experience across asset classes and manager styles

CONS
– Limited operational experience

MONEY MANAGEMENT/BANKS

PROS
– Experience with complex investment solutions such as LDI
– Strong sales and client service functions

CONS
– Conflicts of interest
– Can have specialized areas of focus

BOUTIQUE/DEDICATED OCIO

PROS
– Focus on the endowment, foundation, and pensions management sectors
– Often staffed with experienced former CIOs

CONS
– Lack of resources

Data sources: Cerulli Associates, FEG

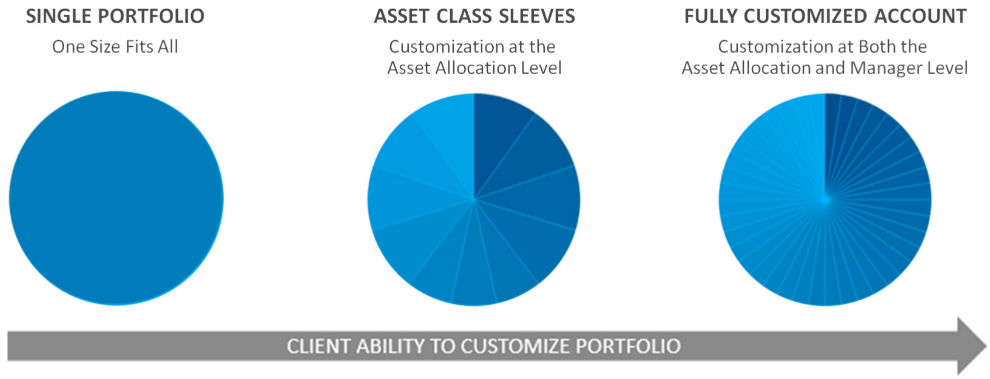
All profiles have something unique to offer, but do not always fit neatly into a specific category. Moreover, there are several firm-specific idiosyncrasies that make such classification even more difficult to assess. Thus, a provider's origin can be a helpful starting point to understanding comparative strengths and weaknesses, but a deeper dive is required to truly understand the profile of an individual firm.

COMMON MODELS

In addition to the inherent strengths and weaknesses of different types of OCIO providers, the design of OCIO portfolios can differ. According to Cerulli, most providers claim to offer custom portfolios. The level of customization can vary considerably, which is why it is helpful to think of these variations as a continuum.

7 aiCIO 2019 Outsourced-Chief Investment Officer Survey

COMMON OCIO MODELS



Data sources: FEG, 2011 Outsourcing Survey, 2009 Outsourcing Survey, Pensions & Investments, Casey Quirk Analysis

At one end of the spectrum is the single portfolio model in which an OCIO provider offers either one portfolio of pooled assets, or a series of portfolios based on risk. In many ways, this model is a one-size-fits-all approach and provides little in the way of customization.

Advantages to the single portfolio model can be economy of scale/negotiating power generated by pooling assets, the simplicity of the approach, and demonstrable investment performance. Disadvantages can include inflexibility, a lack of portability, undue influence by other investors in a pooled fund structure, and potential conflicts of interest if the model does not tout an open-architecture approach.

At the other end of the spectrum, clients desiring greater customization at both the asset allocation and manager level may opt for a fully customized structure. Fully customized portfolios are client-owned portfolios that are managed by an investment advisor. In this case, an OCIO provider truly may serve as an organization's CIO, offering the same flexibility and customization normally afforded to an internal CIO.

A potential advantage of this model is portability—the investor owns the underlying investments in the portfolio rather than a share of a commingled fund—the portfolio can also be customized to meet the unique situation of the investor and provide greater transparency on all portfolio holdings.

Disadvantages of the fully customized model generally pertain to increased complexity (e.g., accounting, operations) and associated costs, as well as reduced benefits of scale. Fully customized portfolios can be expensive and therefore cost-prohibitive for investors with smaller asset sizes.

Models in the middle of the spectrum offer greater flexibility than a single portfolio, but retain some of the economies of scale. A common method of employing this approach is through use of commingled funds, or "sleeves," in which a firm may offer a demonstrated track record for each of its asset class segments. Potential weaknesses of the sleeves approach include lack of portability, limited flexibility, and potential conflicts of interest if the model does not have an open-architecture approach. Ultimately, the type of model utilized should represent each client's specific needs.

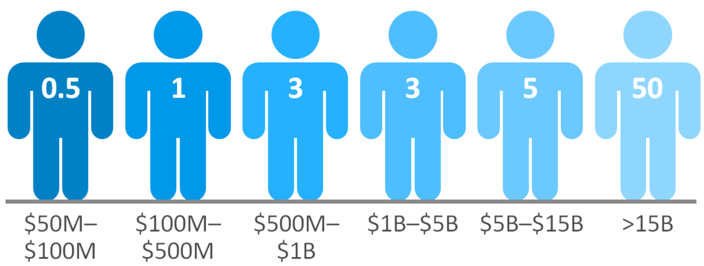
CLIENT PROFILE

As discussed in the evolution of the OCIO model, investment outsourcing originally held broader appeal for smaller institutions, typically those with assets of $100 million or less. However, larger institutions ($100 million - $500 million in assets) currently outsource, or plan to outsource, at a noteable 47% rate. Further, as much as 30% of larger institutions, those with $1 billion in assets, currently outsource or plan to outsource.[8]

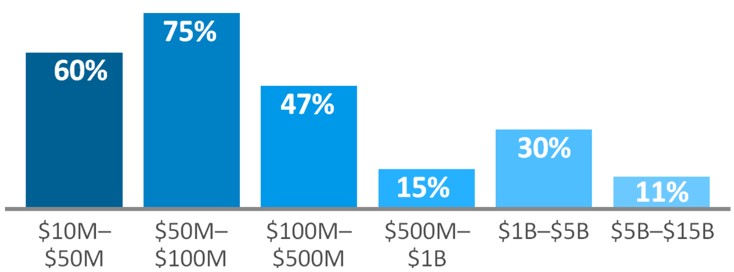
Logically, a core motivation for the increased use of OCIO among clients with mid-range portfolio sizes is evident when considering the asset sizes of those who outsource against the size of the investment staff. Despite the increasing complexity of the investment landscape, institutions with a mid-sized portfolio have, on average, only one staff member, making it improbable that they possess the time and resources necessary to effectively cover the scope of the global investment landscape.

Staff size also may be a factor in the second largest segment of institutions—the $1 billion - $5 billion range—that currently outsource/plan to outsource. With an average staff of three members, institutions with assets between $1 billion and $5 billion have a similarly low staff per assets ratio. Further, institutions with more than $1 billion in assets are more likely to embrace outsourcing a portion of their portfolios, which may further contribute to the growth in this sector.[9]

SIZE OF INVESTMENT STAFF
By Investable Portfolio Size



PERCENT THAT OUTSOURCE / PLAN TO
By Investable Portfolio Size



Note: Asset owners include pensions, nonprofits, healthcare, and family offices.
Data source: aiCIO 2019 Outsourced-Chief Investment Officer Survey

8 aiCIO 2019 Outsourced-Chief Investment Officer Survey.
9 aiCIO 2019 Outsourced-Chief Investment Officer Survey.

UNDERSTANDING THE DIFFERENCES BETWEEN OCIO AND CONSULTING

Confusion remains among asset owners regarding the differences between the traditional consulting model and OCIO. The primary distinction between consulting and OCIO is discretion: in a consulting model, the investor or client retains discretion on both the strategy and implementation, whereas in an OCIO model, the OCIO typically has full discretion over the implementation, but may share discretion over the strategy.

Further differences between the OCIO and consulting models can be seen in the division of specific responsibilities. The responsibilities matrix below breaks this down according to FEG's OCIO and consulting models.

With consulting, the investor sets and executes all aspects of strategy and implementation, including manager and security selection, trading, and rebalancing. The only aspects of responsibility that solely fall on the consultant are risk management from a total portfolio perspective, performance analysis, and reporting.

RESPONSIBILITIES MATRIX

RESPONSIBILITY	CONSULTING	OCIO
Spending Policy/Liabilities Analysis	◆	◆
Investment Policy Statement Development	◆	◆
Asset Allocation Policy	◆	◆
Portfolio Strategy	◆	●
Manager Selection	◆	●
Security Selection	◆	●
Daily Supervision	◆	●
Trading	◆	●
Rebalancing	◆	●
Risk Management	●	●
Performance Analysis	●	●
Reporting	●	●

◆ FEG recommends and monitors; client approves and implements

● FEG executes and monitors; client notified

Source: FEG

In contrast, in an OCIO relationship, the investor—potentially with assistance from the OCIO—determines high-level strategy, with the implementation falling squarely on the OCIO. Regardless of service selected, spending/liabilities analysis, IPS, and asset allocation most often are shared responsibilities between the OCIO and the investor.

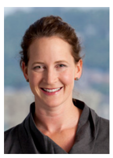
The decision to outsource is a cost-benefit analysis unique to the needs of each organization; there is no right or wrong approach to the level of outsourcing or the division of duties. It is important for asset owners to understand their own strengths, weaknesses, and outsourced needs when considering an OCIO model to evaluate the different options and engage potential providers in candid discussions to find the best match for the institution.

CONCLUSION

The OCIO landscape remains “all over the place” and most likely will continue to have a wide spectrum of solutions until the industry fully matures. Understanding the various models can provide a strong framework for identifying the best solution for your organization. The spectrum of OCIO models can be confusing, but investors can find clarity by asking some of these important questions:

1) What is the origin of your OCIO service provider?
2) Who has the discretion on asset allocation, manager selection, and rebalancing?
3) Can you customize the portfolio regarding asset allocation and/or investment managers?
4) How portable is the portfolio, and how much flexibility is allowed in the approach?

An open dialogue around these questions can assist you in finding a solution that works for your organization. Should you wish to share your thoughts, have further questions, or would like to discuss OCIO at FEG, please contact us at:



Kathryn E. Mawer, CFA, CAIA
Vice President, OCIO Advisor
kmawer@feg.com | 513-719-5139

Gary R. Price
Head of Investment Solutions
gprice@feg.com | 513-719-5101

201 East Fifth Street
Suite 1600
Cincinnati, Ohio 45202

513.977.4400
information@feg.com
www.feg.com

Cincinnati | Dallas | Indianapolis

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