Evaluating the use of an OCIO: A resource for nonprofits

Vanguard commentary

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- Organizations typically frame the decision to use an outsourced chief investment officer (OCIO) as purely investment-based, but active management outperformance of the markets is rare and difficult.
- The true value that OCIOs provide is broader than investing alone. It includes the ability to improve fiduciary oversight, alleviate resource pressures, and more closely align a nonprofit's portfolio to its mission.
- When deciding whether to use an OCIO, organizations should focus on the potential benefits that are more predictable and controllable than investment performance, specifically:
  - Holistic portfolio management
  - Effective governance
  - Lessened administrative/managerial burdens.

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More changes, more challenges

The investment world is constantly changing and evolving. Some developments, such as the globalization of financial markets and decline in investment costs, have clearly benefited investors, but most have made the landscape more challenging. Three changes in particular make the investment-related responsibilities of nonprofit organizations more difficult.

Heightened fiduciary pressures

Industry scandals—highlighted by the Bernard Madoff sham uncovered in 2008—have generated increased scrutiny. Governing agencies as well as industry observers continue to seek more transparency and regulations to prevent similar disasters in the future. Donor scrutiny has also increased recently, trending toward more oversight of the way assets are invested and managed. These changes are well-intentioned and may indeed be beneficial. Nonetheless, nonprofits face greater pressure, and more responsibility falls on the shoulders of already resource-constrained staffs.

A potentially lower-return environment

The strong stock and bond markets of the 1980s and 1990s are now a distant memory. Organizations remain cautious after dealing with the tumult of the tech bubble and the global financial crisis within the past 15 years. Economic conditions continue to improve following the deep recession in 2008. But investors still face a world in which reasonable predictors of stock and bond performance (P/E ratios for stocks, current yields for bonds) suggest ten-year returns below their long-term historical averages (Davis et al., 2014). When everyone is struggling to do more with less, the need for aid from charitable organizations is often greater. Yet the market environment makes it difficult for those hoping to maintain or increase spending without pulling from their principal.

Product and provider complexity

The growing number of products and providers in an already complex industry adds to the challenges. Innovators are certainly welcome, but others may be simply repackaging or rebranding existing strategies and services. For organizations with limited internal investment expertise and/or time, it has become harder to tell the difference.

Seeking solutions

Nonprofit staffs already struggling with time and resource limitations are left to wade through the challenges as best they can. As a result, an increasing number have turned to some version of the outsourced chief investment officer (OCIO) model. According to the 2012 NACUBO-Commonfund Study of Endowments, 40% are currently outsourcing a substantial portion of their investment function (NACUBO, 2013).

Facing intense pressure to grow while continuing to fund their missions, some hope that such outsourcing will yield better portfolio performance. The spectacular results generated by organizations such as Yale and Harvard over the past 25 years may add further pressure as others attempt to achieve such extreme (but rare) success. Exact replication of these structures and strategies is not feasible for most. But sufficient knowledge, discipline, and resources remain critical to long-term portfolio success for all investors.

Note on risk: All investing is subject to risk, including the possible loss of the money you invest.

Organizations desiring to expand the capabilities of their investment function while keeping it in-house must obtain and maintain the right resources. They'll need to consider the costs of hiring, retaining, and supporting an investment staff, including but not limited to salaries, benefits, office space, data licenses, and software. Portfolio reporting and monitoring, as well as other administrative functions, can also be quite costly.

The high level of commitment and organizational change needed to develop in-house investment expertise has led many nonprofits to explore other options such as the OCIO model. But only 33% of those not currently using an OCIO consider themselves "very familiar" with the model and its potential services (Chatham, 2013). This lack of understanding is not surprising, because external investment expertise and other related services can be obtained in numerous ways, many of which may fall into the OCIO category.

What is an OCIO?

A diverse multitude of providers and services makes defining OCIOs difficult. At its core, investment outsourcing describes the transfer of investment duties to an OCIO or third-party discretionary investment advisor. **An OCIO assumes responsibilities formerly entrusted to the board or staff: It determines an asset allocation strategy, selects investment advisors to implement it, and manages its operation and execution.**

OCIO providers range from traditional consultants to boutique investment shops to large asset management firms, and their relationships vary in scope as well. For example, an investment committee may choose to transfer the management of an entire portfolio or a specific asset class, or it may pick and choose among functions to outsource. **Figure 1** provides a more detailed breakdown of the most common options.

Figure 1: Most common options for obtaining external investment expertise

	Traditional consultant	Outsourced chief investment officer
Portfolio		
Implements portfolio changes with ***discretionary authority***		●
Provides committee with portfolio change ***recommendations***	●	
Conducts investment manager search and due diligence	●	●
Manages asset allocation and portfolio rebalancing	●	●
Scope		
Offers access to proprietary research and thought leadership	●	●
Can be hired just for a specific project or investment mandate	●	
Acts as an extension of the committee on a retainer basis	●	●
Serves as a co-fiduciary		●
Committee		
Provides investment committee governance support, best practices, and education		●
Provides investment policy consultation/creation support	●	●
Provides portfolio reporting and data support	●	●

Source: Vanguard.

In many cases, an OCIO may represent not a radical organizational change but rather a slight evolution of roles and responsibilities. Even when the investment office is outsourced, the organization retains primary fiduciary responsibility to oversee the portfolio and ensure it is prudently managed to meet its goals. Fiduciary duty cannot be fully outsourced (see the "Fiduciary standards" box below for further explanation of major fiduciary duties).

Why some organizations choose an OCIO

Nonprofits elect to use an OCIO for a variety of reasons, but a 2013 survey from Chatham Partners provides some insight into the most important. The three most commonly cited were:

1. A lack of internal investment expertise.
2. Concerns over portfolio risk management.
3. Concerns over portfolio performance.

If we look more specifically at why a particular provider is ultimately selected over others, the reasons are similar. Organizations prefer OCIOs that offer potentially superior asset allocation expertise, thought leadership, and investment performance.

Given the pressures they face, this isn't surprising. However, it is important to then ask the question, how satisfied have they been with the ability of their OCIO to meet those expectations?

Drivers of satisfaction

Although OCIO selection is influenced strongly by potential investment success, *just 19% of nonprofits report being "very satisfied" with their OCIO's performance.*[1] It's possible that some OCIOs are overselling their ability to produce benchmark-beating returns, and it's also possible that organizations expect their OCIO to provide unreasonable levels of performance. Regardless of the reason, many aren't getting what they hoped for.

Yet something counterintuitive can be seen in the same organizations' responses: *77% rate their overall satisfaction with their OCIO provider as a 6 or 7 on a 7-point scale* (Chatham, 2013). So, despite dissatisfaction with performance, the vast majority are pleased with the overall relationship. This leads to more questions about the likelihood of OCIOs producing meaningful outperformance and whether they are being selected for the right reasons.

Fiduciary standards

Three major U.S. fiduciary duties for nonprofit organizations under most state laws:

1. **Duty of care:** Fiduciaries must use the same degree of care, skill, and diligence that a prudent person would use in handling corporate affairs. Board members can fulfill their responsibility largely by being informed about matters of importance to the sponsoring organization.
2. **Duty of loyalty:** Fiduciaries must put any personal or private interests aside and always act in the best interest of the sponsoring organization. Self-dealing, conflicts of interest, and even the appearance of impropriety should be avoided at all costs.
3. **Duty of obedience:** Fiduciaries must comply with applicable fiduciary law while keeping the organization true to its mission.

Vanguard's five additional responsibilities essential to good fiduciary conduct:

1. Full understanding of fiduciary liability.
2. Careful organization of the investment committee.
3. Principled investment selection and monitoring.
4. Reasonable and aligned portfolio costs.
5. Diligent administrative oversight.

Source: *Fulfilling Your Mission: A Guide to Best Practices for Nonprofit Fiduciaries* (Vanguard, 2014).

1 Chatham, 2013. "Very satisfied" is defined as a survey response of 7 on a scale of 1 to 7.

Improving the OCIO selection process

What factors can better the odds of improved performance?

Organizations targeting enhanced investment performance typically do so using traditional actively managed strategies and/or alternative investments. The institution or manager must be able to deliver on three factors in order to increase the probability of market-beating returns. Unless all three are present, outperformance is unlikely.

Talent. Talent is challenging to identify and acquire. Among public investors, research has repeatedly shown that the average active manager underperforms its benchmark (Philips et al., 2014). Among alternative investments the story is similar. A minority of managers deliver market-beating returns. And many of the best funds are being closed to new investors, preferring to maintain their existing relationships (Wallick, Wimmer, and Schlanger, 2012). Talented managers are critical to success.

Low cost. Obtaining talent at a low cost is also important. Otherwise, any benefit will likely be washed away by fees. Actively managed investments tend to have expense ratios significantly above those of index funds, creating a high hurdle for managers to clear (Philips et al., 2014). Private alternative investments are usually even more expensive. Many managers charge both a flat percentage of assets under management and a one-sided performance fee, paid only when they generate positive returns. Investing directly (i.e., avoiding additional layers of fees, such as in a hedge fund-of-funds) and negotiating down manager fees are excellent ways to lower the cost hurdle. Unfortunately, only the largest nonprofits—those with over $1 billion—are typically able to do this.

Patience. Patience over the long term is the final ingredient required to create an environment conducive to active management success. Active managers demonstrate little performance persistence from period to period (Wallick, Wimmer, and Martielli, 2013). It's difficult to select and then stick with one that may provide some indication of talent but then occasionally trail its benchmark for extended periods. The natural reaction for many investors is to sell during periods of underperformance, but this only decreases the odds of success (Kinniry et al., 2014).

In sum, active management success is unlikely unless an organization or its selected OCIO 1) has the ability to identify and access scarce talent in advance, 2) can lower investment costs by investing directly and/or negotiating management fees, and 3) is willing to remain committed to its strategy and selected managers for the long term. These traits in combination are rare, and few nonprofits have historically managed to align all three to replicate the Harvard- and Yale-like performance to which many aspire.

We believe organizations would be better served by selecting an OCIO based primarily on non-investment factors, which are more controllable and have a better chance of providing a consistent benefit.

Is it more effective to emphasize more controllable factors?

The value an OCIO can bring to a nonprofit is far more than investment performance alone. OCIOs can serve as true strategic partners. As such, they should be evaluated like other business cases in deciding whether or not to outsource. Their selection should be based on an organization's broad strategy and whether or not the OCIO can help further the overall mission. For example, would it provide a holistic approach to portfolio management, maintain governance best practices, and alleviate administrative/managerial burden? Nonprofits say they are most satisfied with their OCIO's ability to handle these three functions (Chatham, 2013).[2]

Holistic approach to portfolio management. This involves partnering closely with an organization to understand its overall strategy and goals, developing an Investment Policy Statement that aligns with those goals, and maintaining the discipline necessary to adhere to that policy through times of financial market or organizational uncertainty.

Governance best practices. These include educating committee members on governance and fiduciary responsibility, practicing the highest standards of fiduciary care, and maintaining an environment that enables effective fiduciary oversight.

Reduced administrative/managerial burden. Staff members tend to wear many "hats" and face significant pressures due to responsibilities ranging from bookkeeping to fundraising. Some nonprofits may benefit tremendously from outsourcing reporting and other clerical tasks to an OCIO that provides high-quality administration and efficient client service. This can allow internal staff to focus on core operations and strategic initiatives.

2 Chatham Partners survey respondents' top areas of OCIO satisfaction are adherence to investment policy, fiduciary protection, and client service and reporting.

These are certainly not the only important factors. Any organization would also want to take into account more specific considerations such as frequency of interaction, conflicts of interest, and transparency, among others. But evaluating an OCIO's ability to deliver in the areas highlighted above can prove an effective approach. And although the use of an OCIO doesn't relieve the organization of fiduciary duty or oversight, it can allow it to focus more closely on its true mission.

Conclusion

Many organizations deciding whether or not to pursue an OCIO and choosing among potential providers treat the process as primarily an investment decision, allowing performance to take center stage. Unfortunately, achieving superior investment performance tends to be challenging and unpredictable, leading many to express low levels of satisfaction with their OCIO's ability to beat the market.

It can be more effective to focus on broader organizational issues for which OCIOs can provide more predictable and controllable benefits. These might include the creation of and adherence to an Investment Policy Statement, the improvement of governance and fiduciary practices, and the lessening of administrative and managerial burdens.

Although investment performance is certainly important, the true value an OCIO can offer is much deeper and broader. Organizations should keep this in mind as they seek solutions to the mounting pressures they face.

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Appendix: Weighing your options—Considerations for investment outsourcing

An organizational evaluation can facilitate a robust discussion about whether an OCIO structure would meet an organization's needs. To help initiate these discussions, we've provided a worksheet that includes some key decision points.

The scale below identifies the importance of potential issues facing an organization and rates how successfully they are currently being addressed. Although this list is not exhaustive, investment committees can use the worksheet to generate productive conversation. If numerous categories of high importance have a low level of current success at addressing, it may be beneficial to reevaluate your investment/organizational structure.

Aligning the portfolio to organizational objectives

	Level of importance (Low – High)	Current success addressing (Low – High)
Creating and adhering to a comprehensive and well-written Investment Policy Statement that links the organization's goals and investment portfolio	○ ○ ○ ○ ○	○ ○ ○ ○ ○
Setting an asset allocation that is aligned with the organization's risk tolerance and spending needs	○ ○ ○ ○ ○	○ ○ ○ ○ ○
Monitoring and rebalancing the portfolio in a disciplined manner	○ ○ ○ ○ ○	○ ○ ○ ○ ○

Enhancing fiduciary oversight

	Level of importance (Low – High)	Current success addressing (Low – High)
Providing committee members with the appropriate information to make effective fiduciary decisions	○ ○ ○ ○ ○	○ ○ ○ ○ ○
Creating and maintaining strong controls regarding financial operations, trading, counterparties, valuations, and compliance	○ ○ ○ ○ ○	○ ○ ○ ○ ○
Enabling the committee members to focus on broad strategic investment issues rather than investment- or manager-level details	○ ○ ○ ○ ○	○ ○ ○ ○ ○

Obtaining needed resources and investments cost-effectively

	Level of importance (Low – High)	Current success addressing (Low – High)
Attracting and retaining administrative resources and investment expertise	○ ○ ○ ○ ○	○ ○ ○ ○ ○
Ensuring that the level of administrative resources, software/systems, and investment expertise is sufficient for the complexity of the organization's portfolio	○ ○ ○ ○ ○	○ ○ ○ ○ ○
Optimizing total investment/portfolio related costs	○ ○ ○ ○ ○	○ ○ ○ ○ ○

Source: Vanguard.

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