

An Outsourced Chief Investment Officer (OCIO) Debate

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Session Outline

- Glossary of terms
- The role of an OCIO
- Reasons to "Go OCIO"
- Challenging the model: Two sides of the coin
- Importance of fiduciary oversight
- Benefits and potential pitfalls
- Key takeaways

Glossary of Terms

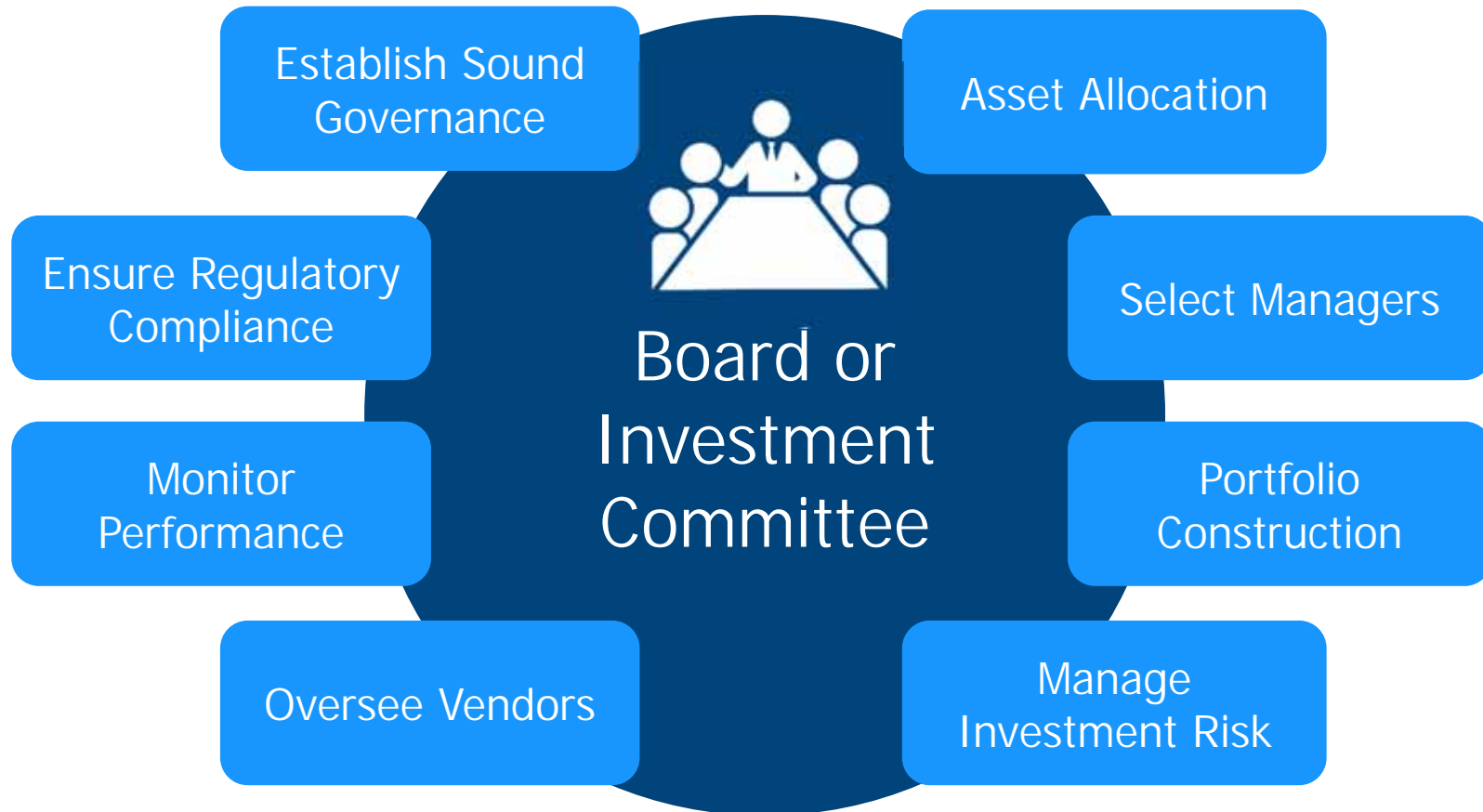
Glossary of Terms

- OCIO—Outsourced Chief Investment Officer
 - 3(38) Discretionary Advisor or OCIO
 - 3(21) Non-discretionary Consultant—Traditional model
- AUM—Asset Under Management
- AUM Fee—A fee based on a percentage of AUM
- IPS—Investment Policy Statement



The Role of an OCIO

Plan Sponsor: Responsibilities



An OCIO Has Discretion to Decide



Investment Policy

- Manage and update policy
- Either OCIO or Trustees execute



Strategic Asset Allocation

- Optimize the mix of asset classes (stocks, bonds, alternatives)



Investment Managers

- Negotiate investment management fees
- Offer aggregated fee arrangements (may reduce costs)

An OCIO Has Discretion to Implement



Rebalancing

- Act quickly and effectively



Retaining or Removing Managers

- Reduce implementation delays and/or errors



More Efficient Operations

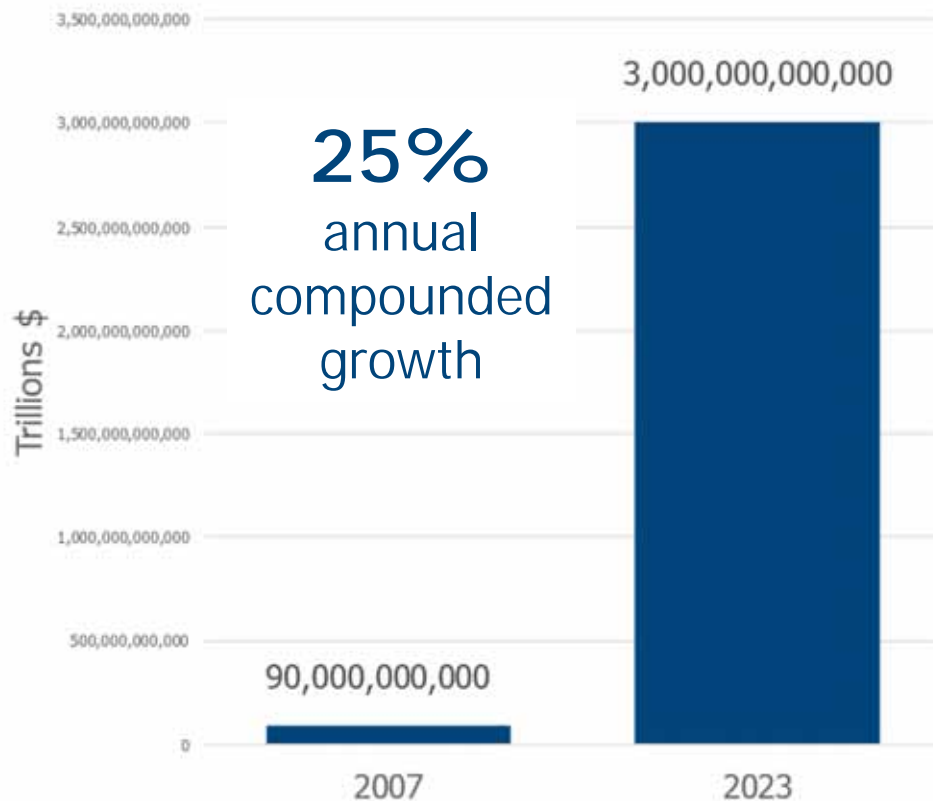
- Contract review and negotiation
- Document retention
- Operational support

OCIO vs. Consultant

	Board	3(21) Consultant	Board	3(38) OCIO
<u>Strategy</u>				
Define Objectives/Plan design	✓		✓	✓
Set Investment Policy	✓			✓
Asset Allocation	✓			✓
<u>Implementation</u>				
Manager selection	✓	✓		✓
Manager termination	✓	✓		✓
Negotiate contracts and fees	✓	✓		✓
<u>Evaluation</u>				
Performance monitoring	✓	✓		✓
Manager oversight	✓	✓		✓
Monitor Consultant or OCIO	✓		✓	

Reasons to "Go OCIO"

The Growth of OCIO



Fastest growth sector:

Number of DC clients outsourcing plan assets, up 39% in 2023 to 29,814

Source: Pensions and Investments, Cerulli Associates

Growing Investing Complexity

▶ 1970s	▶ 1990s	▶ 2000s	▶ Today . . .
U.S. Stocks	U.S. Stocks	U.S. Stocks	U.S. Stocks
U.S. Bonds	U.S. Bonds	U.S. Bonds	U.S. Bonds
	Real Estate	Emerging Markets	Multi-Sector
	International	Private Equity	Multi-Asset
	High Yield	Hedge Funds	Smart Beta
	Small Stocks	Derivatives	Risk Parity
		Securities Lending	ETFs
		Real Estate	Emerging Markets
		International	Private Equity
		High Yield	Private Debt
		Small Stocks	Hedge Funds
		Specialist Managers	Funds of Funds
			Derivatives
			Venture Capital
			Mezzanine Debt
			Securities Lending
			Real Estate
			International
			High Yield
			Small Cap Stocks
			Specialist Managers
			Factor Funds
			Replicator Funds
			Frontier Markets
			Pvt. Placements
			Portable Alpha
			130/30
			Dynamic AA
			Commodities
			Infrastructure
			SRI
			ESG
			DEI

Benefits of Investment Outsourcing

Investments

Potential for
Reduced Fees

Potential for
Improved
Outcomes

Governance

Improved
Governance
Support

Mitigate
Fiduciary
Risk

Operations

Faster Decisions
Less Delays
Accountability

Reduced
Administrative
Responsibility

Case Study 1: Improved Options and Fees

Small-to-Medium-Sized Pension Plan

Issue

Plan paid high investment fees and could not participate in the most attractive investments due to its asset size.

Impact

Plan could not invest in the lower fee options and was overly reliant on the stock market due to its inability to invest in many attractive private investments.

Solution

Moving to an OCIO model allowed the plan to "piggyback" on the OCIO's total assets to qualify for highly desired investments and reduced fees.

Case Study 2: Performance and Time

Contentious Health and Welfare Board

Issue

Board argued over health care issues which delayed important investment decisions (new asset classes, remove poorly performing accounts).

Impact

Investment portfolio was not properly diversified and performed poorly.

Solution

Transferring investment decision-making to OCIO advisor led to better performance and shorter meetings.

Case Study 3: Fiduciary Liability and Decisions

Concerned Defined Contribution Trustees

Issue

Board concerned about widespread litigation around investment fees, options and performance.

Impact

Trustees felt pressure when making investment decisions and were concerned it led to incorrect investment choices.

Solution

Transferring investment decision-making to OCIO advisor reduced Trustee liability and reduced the number of Trustee decisions.



Challenging the Model: Two Sides of the Coin

Challenging the Model: Two Sides of the Coin

- Not every plan needs to “go OCIO”
 - If you are a long-term and disciplined investor, OCIO may be a solution to a non-existent problem
 - There is no evidence that OCIO-managed plans perform better
 - According to NASDAQ/Alpha Capital OCIO Universe data as of 6/30/2024 for last 10 years:

Index	MRQ	1 YR	3 YR	5 YR	7 YR	10 YR
Defined Benefit Pension Plans Index	0.31	7.64	-0.95	4.38	5.07	5.17
60% S&P 500 / 40% Bloomberg Barclays US Aggregate	2.60	15.42	4.84	9.01	9.04	8.38

Source: www.alphanasdaqocio.com

Challenging the Model: Two Sides of the Coin

- OCIO = Single point of failure
 - Idiosyncratic risk due to no **strategic** diversification
- Many benefits of using multiple OCIOs
 - Diversify idiosyncratic risk of lone OCIO
 - Become a higher priority client
 - Hear different perspectives, eliminate “echo chamber”
 - Create comparative/competitive environment
 - Following same IPS = Apples-to-apples comparison
 - Keeps benchmarking honest and objective
 - Inter-OCIO rebalancing opportunities now possible

Challenging the Model: Two Sides of the Coin

- Percent of AUM fee is a flawed fee structure
 - AUM fluctuates due to markets, cash flows and OCIO value add. **The first two factors are known**
 - OCIO fee can increase when OCIO is losing value
- Flat fee: Ends higher-fee-and-lower-value issue
- Performance-based fee: Better aligns interests and protect trustees from over-paying for OCIO services



Importance of Fiduciary Oversight by Trustees

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- Beware the OCIO fee trap
 - ERISA demands paying only *reasonable* fees
 - Possible to pay more with percent of AUM fee even if OCIO is costing value with poor investment decisions
 - 2012-2021 doubling of fees with bottom decile returns averaging 7%
 - Paying more for suppressed returns creates an easily *discoverable and measurable* fiduciary breach

Importance of Fiduciary Oversight by Trustees

- Is my OCIO too big to succeed? ←New Duty
 - Capacity constraints and bottlenecks
 - Lack of nimbleness for tactical and rebalancing
 - Liquidity and funding queues
 - Manager Selection, hiring and firing
- Where is your fund's priority? ←New Duty
 - How does your OCIO prioritize clients for execution, manager selection, rebalancing, etc.?
 - Remember, this is reason to have multiple OCIOs

Importance of Fiduciary Oversight by Trustees

- Trustees are outmatched; difficulty monitoring
 - The “player keeps score”
 - Goodhart’s Law—“When a measure becomes a target, it ceases to be a good measure.”
 - Total plan benchmark manipulation—“Phantom Alpha”
 - Benchmark linking, strawman benchmarks, retroactive benchmarks, mis-weighted benchmarks
 - Universe shopping
 - Incomplete feedback loops for manager and asset allocation changes

Importance of Fiduciary Oversight by Trustees

- Independent, third-party evaluator ←New Duty?
 - One-time or ongoing
 - Be wary of competitor or search provider
 - Avoid conflicts of interest
 - Proactive legal protection with greater fulfillment of duty to monitor, and overcome OCIO fee trap
 - OCIO will gain valuable feedback and attribution analysis to improve future outcomes
 - *Tibble v. Edison* and *Hughes v. Northwestern*



Benefits and Potential Pitfalls

Benefits and Potential Pitfalls

- Clearly defined duties and ownership of returns
- Saves Trustee time at meetings
- Potential for better risk-adjusted returns and lower fees
- Puts decision in the hands of the experts
- Nimble decision making and risk management
- **“Stay in your lane”**
 - Do not get pulled back into investment decisions
 - Manager selection—Do not hint, suggest, guide, etc.
 - Asset allocation—Set broad guidelines that do not need to be changed frequently

Benefits and Pitfalls

- Beware “hybrid” or “pseudo” OCIO models
 - Quicker execution with “rubber stamp” by trustees
 - Less due diligence by trustees and investment committee
 - Does not convey 3(38) status
 - Trustees do not offload any fiduciary responsibility
 - Maintains blurred ownership of returns
 - 3(21) consultant lowers workload, but often receives a pay increase

Key Takeaways

- A growing number of employee benefit sponsors have turned to outsourced chief investment officers (OCIOs).
- OCIO benefits include fiduciary relief, a better governance approach, cost savings, and nimble risk management.
- OCIO model streamlines the process
 - Faster execution, eliminates conflicts
 - No proof performance will improve
 - Not every plan needs to “go OCIO”
- Trustees’ duty to monitor changes
 - OCIO capacity, player-keeps-score
 - OCIO fee trap fiduciary breach
 - Consider independent monitoring

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Session Evaluation

