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# The OCIO checklist manifesto

**Eric S. Menzer** | Six considerations in selecting an OCIO

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## Six outsourcing considerations for pension plan sponsors

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### Key takeaways

- As more organizations sharpen the focus on their core competencies, many are starting to question the cost-effectiveness of maintaining large in-house investment departments, and many firms are seeking the help of outside expertise in navigating today's complex markets.
- The outsourced chief investment officer (OCIO) fiduciary model is gaining traction among pension plan sponsors and other institutional investors, as worldwide OCIO assets under management grew to over $1.5 trillion in 2017, up more than 14% from the prior year.[1]
- While pension plan sponsors are intrigued by the prospect of an external discretionary partner to serve as a co-fiduciary, many are bewildered by the different permutations of OCIO services available and uncertain about what—exactly, they really need.

## Executive summary

With the increasing stringency of fiduciary standards and the growing complexity of financial markets, fewer institutions today are willing to go it alone when it comes to managing their own investments, whether the assets reside in a pension plan to support the organization's employees or an endowment fund to support its operating budget. Consultants have long aided institutional investors in need of advice, but more OCIO providers are stepping forward with comprehensive fiduciary services combining advice, portfolio management, and plan administration—all through a single point of contact. OCIO assets under management in the United States alone are projected to reach nearly $1.7 trillion by 2023.[1] While the word is clearly getting out, many institutional investors still wrestle with the best ways to match their specific needs with the right combination of OCIO service options available from different providers in the marketplace. Fully funded or not, each pension plan is unique, requiring its own specific combination of OCIO service capabilities. Here, we offer a checklist of six items a plan sponsor can consider to maximize the odds of engaging an OCIO with the capabilities and expertise best suited to help bridge the gap.

## 1 Asset allocation credentials are essential

It's not easy being a defined benefit plan sponsor these days. "The latest dive in interest rates pushed the global stock of negative-yielding debt above $15 trillion for the first time," representing roughly a quarter of all outstanding bonds around the world—a development that "further complicates the life for pension funds," according to Grant's Interest Rate Observer.[2] Investments with expected rates of return sufficient to meet projected liabilities are becoming harder to find, which makes asset allocation that much more crucial. The average U.S. corporate pension plan now stands at less than 84% funded, down from 94% in September 2018.[3] Pairing increasingly onerous legal and regulatory burdens against a macro backdrop rife with historical anomalies, it's no wonder plan sponsors are growing uncomfortable going it alone.

While devoting greater resources toward core business capabilities has become a competitive imperative, many nonfinancial organizations lack in-house staff with the asset allocation expertise needed to navigate an upside-down investment world populated with subzero yields. Not surprisingly, the majority of institutional investors (51%), including 53% of corporate defined benefit plans, identified asset allocation as the most valued investment service provided by OCIOs.[4] Asset allocation decisions should take into account a plan's characteristics, its asset-liability mismatch, its current yields, and its most optimal path toward return expectations that meet its discount rate.

Even an organization backed by a strong investment committee that meets quarterly may benefit from the agility afforded by day-to-day external discretion. "Formerly, it was hard to react when an investment opportunity would present itself. By using an OCIO we are creating structural expertise that helps us with these one-off ideas," notes one investment committee chair.[4] Asset allocators have the potential to add alpha and control risk by dynamically seizing the opportunities that unexpected market dislocations provide. A seasoned multi-asset solutions team with an extensive active asset allocation record using in-house and third-party strategies across many different public and private asset classes may provide plan sponsors with an improved efficient frontier and a better hedge ratio over time.

While strong consulting credentials might be sufficient in the context of a limited engagement advisory relationship, some "OCIOs are consulting firms that have expanded into the field of outsourcing to increase their fees."[5] Full fiduciary responsibility is probably best left to OCIO firms designed with asset allocation in their DNA right from the start.

### CHECKPOINT

- Favor OCIOs with a history of asset allocation leadership and innovation.

### Asset allocation and manager research top the list of client needs

| Investment services | Total | Nonprofits | Corporate DB plans |
|---|---|---|---|
| Manager due diligence selection/termination | 51% | 52% | 47% |
| Asset allocation (strategic and/or tactical) | 51% | 43% | 53% |
| Alternative investment capabilities and access to top-tier managers (including co-investing) | 24% | 48% | 0% |
| Pension-specific capabilities (LDI, custom glide path) | 24% | 0% | 58% |
| Purpose-driven investing (ESG) | 9% | 14% | 0% |
| Execution | 4% | 5% | 5% |
| Other | 16% | 24% | 5% |

Source: "OCIO at an Inflection Point," Cerulli, 2019.

## 2 Multimanager diversification requires robust manager research

When it comes to managing an institutional portfolio, asset allocation might be among the most important things, but it's not the only important thing. In fact, 51% of all institutional investors identified manager due diligence, selection, and termination as the most valued investment service provided by OCIOs, an acknowledgment that diversification should extend beyond asset classes and include multiple investment styles from multiple investment firms.[4] As capital markets have become increasingly complex and more institutions have come to embrace private investments and other alternative assets, no single organization today can reasonably expect to achieve proficiency in every investment discipline needed to help build a truly diversified portfolio.

### Devoting all assets to a single underlying manager entails risks

In addition to potentially forfeiting niche market opportunities, pension funds that consolidate their assets with only one asset management firm for all of their underlying investments may introduce an unintended degree of manager concentration risk. An academic study on management structure at investment firms suggests a strong link between hierarchy and herding, the tendency of portfolio managers to follow the trading behavior of their colleagues.[6] In particular, a firm with a vertical structure, where house views are mandated from the top down, can impair a portfolio manager's discretion and sense of empowerment, weakening the incentive to cultivate original insight. And when all of a firm's portfolio managers rely on the same central research group, it's fair to question how they guard against groupthink. An OCIO provider offering a robust open-architecture platform featuring third-party managers sends a strong signal to prospective clients about its commitment to minimizing conflicts of interest, maintaining high fiduciary standards, and creating a broad range of investment opportunities—all while reducing manager concentration risk.

### Not all OCIOs are resourced for global investment manager research

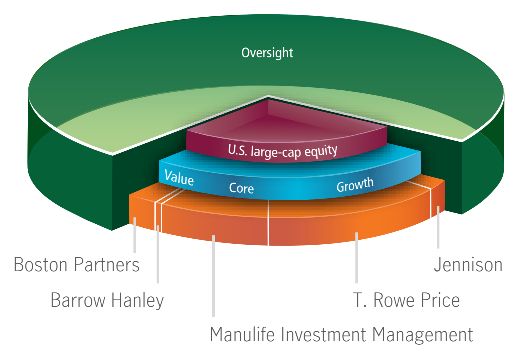
But aspiration isn't execution. Implementing multimanager diversification in practice requires substantial research and oversight resources, including a dedicated staff specializing in investment manager due diligence and oversight, and advanced analytics and performance attribution systems. Despite their good intentions, some OCIO providers just don't have the scale to maintain manager research coverage spanning scores of talented investment teams and the hundreds of different strategies that they run. Only some providers routinely engage third-party specialized "managers with expertise outside their own, particularly in alternative assets and private market investments."[1] An OCIO is only as good as the asset manager network it's able to bring to bear on behalf of its client accounts.

### CHECKPOINT

Favor OCIOs that bring together some of the best investment teams from around the world.

### Open-architecture fund construction helps mute manager concentration risk

- **Oversight**
  Monitoring each portfolio team for the repeatability of its investment process and management of risk
- **Multiple asset classes**
  Both within and beyond traditional equity and fixed income
- **Multiple styles**
  Continual exposure to a variety of strategies, as different characteristics go in and out of favor
- **Multiple managers**
  A diversity of approaches from some of the world's best managers




Source: John Hancock Investment Management, 2019. For illustrative purposes only.

## 3 Private-market assets can pair well with long-duration obligations

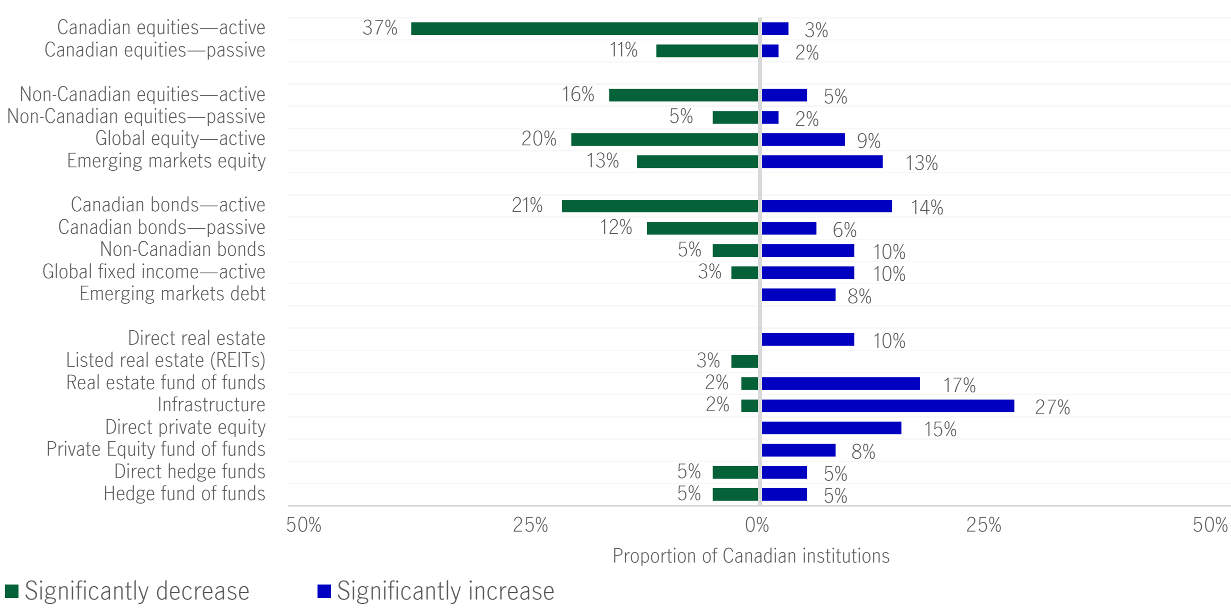
Over 60% of alternative asset holders believe we're near the peak of the equity market cycle.[7] Still, the average corporate defined benefit plan remains less than 84% funded.[3] What's the game plan to close the gap? Most mainstream asset classes probably won't do the trick; "with the bond market offering microscopic yields (at best) and the S&P 500 trading at a substantial premium to its five-year average on price-to-earnings basis, pension funds look primarily to the private markets to make up the shortfall."[2] In fact, 70% of U.S. corporate defined benefit plans expect to increase their allocations to real estate, infrastructure, private debt, and other private investments over the next year; meanwhile, 78% plan to decrease their allocations to public equity markets over the same period.[1]

Private investments span diverse asset classes across the capital spectrum, yet they all share a common feature—they're not publicly traded. As a result, private assets can offer an opportunity to pursue an illiquidity premium over stocks, with lower day-to-day price volatility along the way. Increases in allocations to "defensive positions that are less correlated with public market investments" are anticipated across a variety of "client types with longer-term investment horizons that are willing to trade liquidity for higher returns than are available in public markets."[1] Across the endowment and foundation world, too, the allure of private assets remains as strong as the aversion toward public equities. Over the next year, 6 of every 10 U.S. endowment funds expect to increase allocations to real estate, infrastructure, private debt, and other private investments while decreasing allocations to public equities.[1] Nearly a third (31%) of nonprofits report a greater need for opportunities to allocate capital to private-market strategies as a co-investor alongside their OCIO provider.[4] Candidates affiliated with insurance companies often have a leg up in this regard since they can frequently offer clients the same private-market strategies the insurer deploys on its balance sheet to meet its own financial obligations.

### CHECKPOINT

Favor OCIOs armed with an arsenal of alternatives, fortified by private-market expertise.

**Real estate, infrastructure, and other private investments are on the rise**
Canadian institutions' expected allocation shifts over next three years




Source: Canadian Institutional Investors Research, Greenwich Associates, 2018.

## 4 Liability-driven investing is indispensable for pension risk management

Given where we are in the market cycle, many corporate defined benefit plans see now as the time to upgrade their risk management capabilities through dynamic glide paths, completion mandates, derivative overlays, and other liability-driven investment (LDI) strategies. Whereas the absolute asset price volatility often represents the most prominent definition of risk for total return investors, asset price volatility relative to the liability stream remains the risk most likely to instill insomnia for pension plan sponsors. Here again, OCIOs affiliated with insurance companies have a clear edge over candidates that aren't so well versed with the liability side of a balance sheet.

Long duration government bonds have historically served as the bread and butter of pension fund LDI, and debt remains in demand—over two-thirds of defined benefit plans anticipate increasing their fixed-income allocations over the next year.[1] Still, abnormally low and even negative sovereign bond yields have left plan sponsors "forced into increasingly 'creative' measures to maintain rates of return sufficient to meet their obligations."[2] Insurers have been facing the same type of asset liability matching challenge for years. An OCIO with a heritage of risk management, deep actuarial expertise, and a wide range of derisking and return-enhancing tailored solutions may be better equipped to help a plan sponsor achieve its target objectives, even as they change over the pension fund's lifecycle.

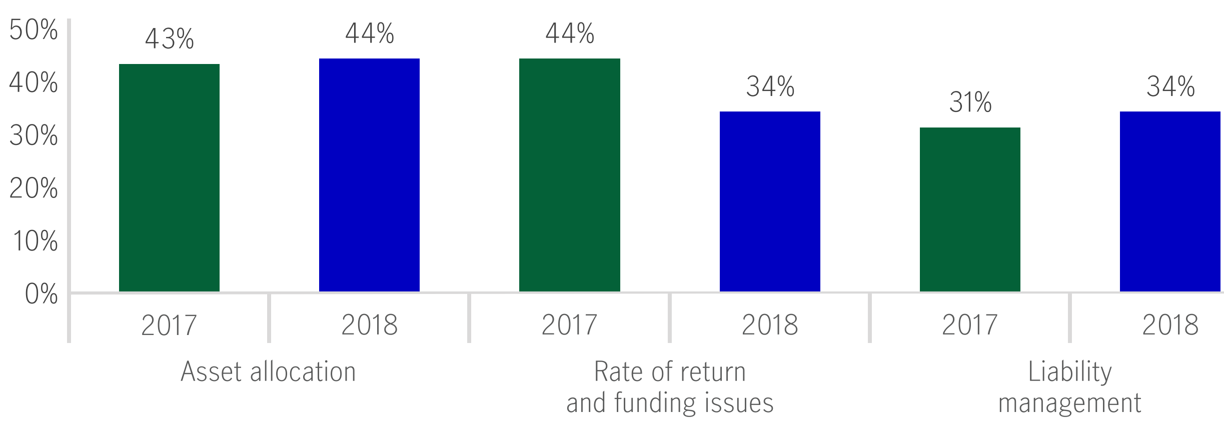
Pension fund asset allocation can't exist in a vacuum. Dynamic glide path management is an active derisking approach, whereby the asset mix is adjusted gradually, based on client-specific fund characteristics, in an effort to narrow the gap between the present value of a plan's assets and its liabilities over time. Over half of all U.S. OCIO-managed corporate defined benefit plan assets are on a glide path of some sort.[1]

For plan sponsors lacking such sufficient skills internally, finding an OCIO capable of tailoring and implementing an LDI approach can increase the odds of better outcomes over the long run. A good LDI process requires an integration of quantitative and actuarial insight with client-specific considerations concerning objectives and constraints. By maintaining a collaborative LDI program throughout the life of the plan, a joint client-OCIO partnership can explore enhancements and make adjustments to meet the changing needs of the plan over its lifecycle.

### CHECKPOINT

- Favor OCIOs that recognize a plan's investment strategy starts with its liability profile.

**Liability management is among the top three concerns among Canadian corporate plans**
Proportion of Canadian corporations facing three key issues, 2017 and 2018




Source: Canadian Institutional Investors Research, Greenwich Associates, 2018.

## 5 Administrative acumen is central to comprehensive plan management

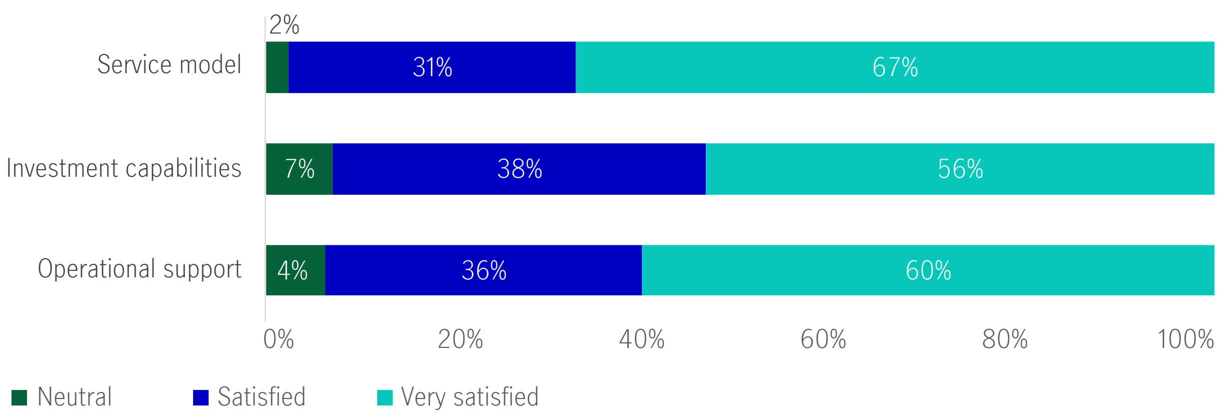
A truly comprehensive OCIO-plan sponsor relationship doesn't end with investment policy advice, asset allocation implementation, manager selection, or customized portfolio solutions. While plan sponsors often overlook the capability to conduct administration services in the search for the right OCIO, such an omission can prove immensely inconvenient—and costly—in the long run, especially for pension plans with a large number of participants. Administrative offerings run the gamut in the OCIO marketplace. Some providers offer virtually none while others can combine integrated front-, middle-, and back-office functions ranging from foreign exchange and securities trading, actuarial and defined benefit recordkeeping services, transition management, custodial services oversight, transactional and financial reporting, securities lending, and equitization of cash. Only insurers can provide comprehensive pension administration services in Canada, and a strong OCIO provider can provide its clients with an advantage in coordinating communications with the custodian and handling all activities associated with pension payments on the plan's behalf.

Clients value custody, recordkeeping, and trading relationships and other ancillary support services, such as reporting and technology—especially if they can be accessed through a single point of contact. An executive at a $1.3 billion corporate defined benefit plan observed that "our fee structure is better than it was pre-OCIO, and when you add on top of that the fact that you get the portfolio expertise and administrative support, it just makes a lot of sense" (emphasis added).[4] Some OCIOs may be able to serve one or more facets of a plan's management, but relatively few can bring together all the essentials of operational excellence into a holistic solution that includes administrative services. Still, if they make the effort to find the right partner, plan sponsors can benefit from complete OCIO plan management bolstered by administrative efficiencies, cost controls, and economies of scale that only come with significant consolidations in pension plan services purchasing power.

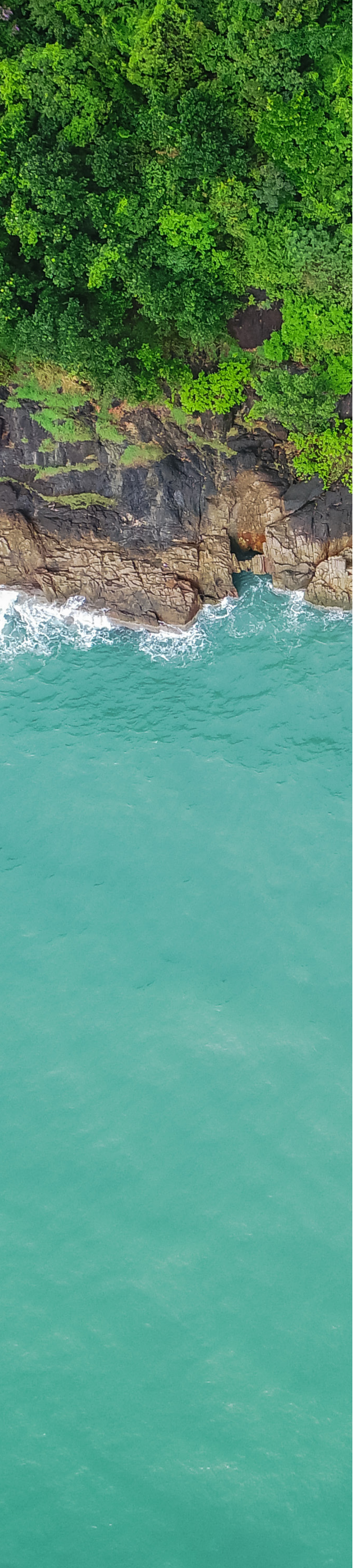
### CHECKPOINT

Favor OCIOs offering complete plan management—down to the last administrative detail.

### Institutions desire more than investing from their OCIO providers




Source: "OCIO at an Inflection Point," Cerulli, 2019.



## 6 OCIO search consultants can help if you get stuck

Finding the right OCIO partner isn't easy for pension plans and other institutional investors. Rather than a perfect science, striking the right match is more of an iterative art. And it's not only prospective clients that get confused: 84% of U.S. OCIO providers also view the "lack of a developed process for searching, evaluating, and selecting OCIO services" as a challenge.[1] That may change as the OCIO market matures and as its professional matchmakers continue to gain momentum and establish a more prominent role in the shaping of OCIO search best practices. Across the universe of OCIO providers, 45% report seeing only a small sliver of prospective client searches—less than one-quarter—tied to OCIO search consultants, while 42% estimate that one-quarter to one-half of the searches they encounter come from consultants. The remaining 13% of the OCIO providers see a majority of searches led by consultants.[1] These numbers are expected to shift. We expect search consultants to fare well as the volume of informal market checks, rebids, and full-blown replacement searches grows along with the maturity of the OCIO marketplace. Many OCIO clients that didn't initially use a search consultant report plans to do so in the future because they believe it will help them save time, review a larger number of providers, and conduct a more efficient search.[1]

### CHECKPOINT

When in doubt, seek out an OCIO search consultant to help you strike the right match.

## What to do now

In theory, finding the right OCIO seems like a fairly straightforward exercise. But challenges arise in the practice of identifying service providers with the right mix of expertise, judgment, and technical skills. Each pension fund is unique, requiring its own specific combination of OCIO service capabilities. Here, we briefly recap our checklist of key items a plan sponsor can consider when seeking out the right OCIO for the job. Favor OCIOs that:

1. Demonstrate an extensive track record of asset allocation leadership and innovation
2. Bring together some of the best investment teams from around the world
3. Arm clients with an arsenal of alternative investments, fortified by private-market expertise
4. Recognize a plan's investment strategy should be developed in light of its liability profile
5. Offer comprehensive plan management—right down to the last administrative detail
6. Earn and deserve the respect of the OCIO search consultant community as the investment outsourcing market matures, with search consultants playing a more prominent role in it

**1** "U.S. Outsourced Chief Investment Officer," Cerulli, 2018. **2** Almost Daily Comment, Grant's Interest Rate Observer, 8/6/19. **3** milliman.com/pfi/, 9/18/19. **4** "OCIO at an Inflection Point: Strong Growth Ahead, but Institutions Are Demanding More," Cerulli, 2019. **5** "OCIO RFPs: Are you asking these key questions?" Strategic Investment Group, 2014. **6** "The Role of Organizational Structure: Between Hierarchy and Specialization," Massimo Massa and Lei Zhang, 2010. **7** Preqin investor survey, November 2018.

**Manulife Investment Management**

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