



Outsourced investment management: **what it offers** the long-term investor

Increasingly, institutional investors—many with very large asset pools—are choosing to focus on mission and fiduciary responsibilities and turn to the outsourced model for investment management.

by Sarah Clark, Managing Director and Head of Strategic Solutions, and Stuart Ames, Managing Director, Strategic Solutions, Commonfund

Outsourced investment management can be a confusing term. The implications of the concept have certainly changed over the years, and many different kinds of firms now tout their outsourcing capabilities. However, their services can vary markedly from each other, leading to valid questions about what actually constitutes outsourcing. Yet one trend is clear: More and more organizations are outsourcing the management of their investment portfolios in some form or another. Once outsourcing was a concept that only small firms considered. Now bigger institutions are also finding benefits to outsourcing the management of their investments. The outsourcing model has come of age during the last 10 years, which has been a time of great market and economic turmoil. This environment has exposed the difficulty and cost of managing institutional portfolios. This article seeks to answer some of the questions institutional investors have about outsourcing and offers ways of thinking about the outsourcing decision.

Why are more institutions outsourcing? One major factor is the increasing complexity of investments. There was a time when portfolios consisted of a traditional mix of stocks, bonds and cash. Today's portfolios would be barely recognizable to the typical investment committee of a few decades ago. Not only have alternative strategies proliferated, but they also demand greater analysis, due diligence and monitoring. The investment process is far more time- and resource-intensive than ever before. Complexity and more broadly diversified portfolios also give rise to the need for specialists with specific knowledge, experience and skill sets, e.g., understanding a relative value hedge fund is vastly different than digging into a potential oil and gas investment.

This links to another reason for outsourcing—limited resources among institutional investors. Despite the growing complexity, nonprofit institutions have not responded by committing greater human

resources to investment management. Evidence of this comes from recent Commonfund Benchmarks Studies®, which are annual surveys of the investment management and governance practices of educational endowments, foundations, operating charities and nonprofit healthcare organizations. Over the years that these nationwide surveys have been conducted, levels rise and fall somewhat but:

- The average number of full-time employees devoted to investment management hovers around 1.2 to 1.4.
- The average number of investment committee members is about eight.
- Only about half of investment committee members are investment professionals.

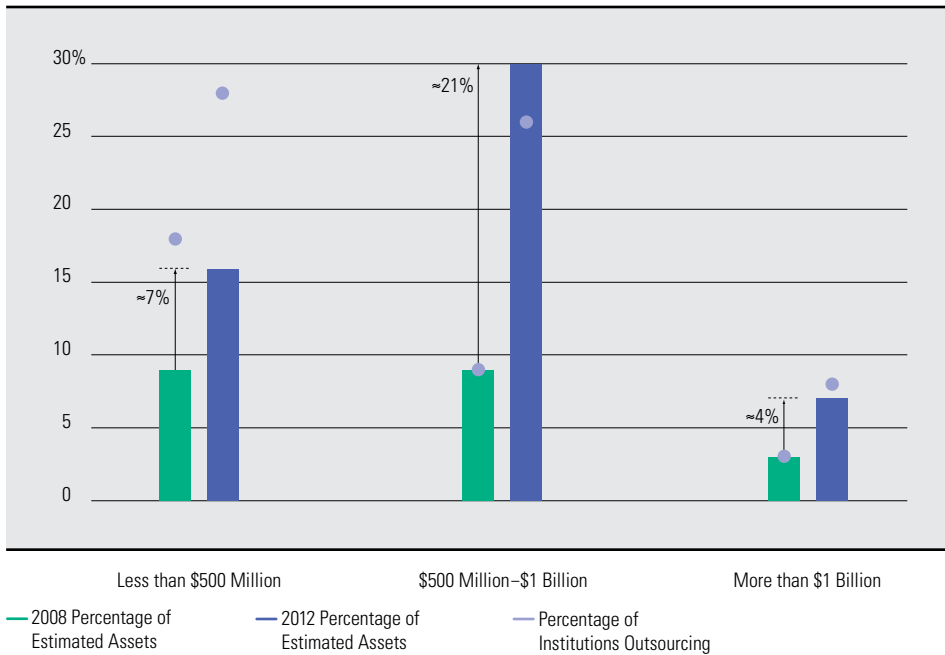
Another factor accounting for the growth of outsourcing is the difficult environment investors have encountered in the capital markets of recent years. The steep declines of 2008 and early 2009 left many institutional investors with losses of more than 20 percent in their asset pools—a drop that may require many years to recover. As a result, risk management has moved to the forefront as a primary discipline alongside return generation. Yet, institutional investors and traditional consultants are hard-pressed to develop effective risk management programs.

Not only have capital markets become more difficult to navigate, but the awareness of governance requirements and fiduciary responsibilities has also increased. Trustees, investment committee members, and senior financial and investment staff have a much longer checklist of things they must ensure are being monitored and managed appropriately. The traditional task of picking and monitoring managers has turned out to detract from the amount of time devoted to and the quality level of discussions required for adequate policy-making and governance in today's environment. Outsourcing is an alternative that has the potential to allow trustees to better fulfill their fiduciary responsibilities.

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PERCENTAGE OF U.S. INSTITUTIONS OUTSOURCING INVESTMENTS IN THE NONPROFIT MARKET

2008 versus 2012 (Estimated)



Source: Casey Quirk, *The New Gatekeepers: Winning Business Models for Investments Outsourcing*, December 2008

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These issues are not confined to smaller institutions. If anything, complexity, governance matters and fiduciary responsibilities increase along with size. That accounts for the greater acceptance of outsourcing among larger institutions. Casey Quirk—a research and consulting firm specializing in the financial industry—estimates that the greatest growth in outsourcing over the period from 2008 through 2012 will come from nonprofit institutions with assets between \$500 million and \$1 billion, not from institutions with assets below \$500 million as shown in the chart above, *Percentage of U.S. Institutions Outsourcing Investments in the Nonprofit Market*. The companion chart on the following page, *U.S. Institutional Investments—Outsourcing Market*, looks at the projected growth in assets and the number of institutions over the same period of time. According to these estimates, outsourced assets will more than double over the period, while nearly 1,000 more institutions will be outsourcing investment management in 2012 compared with 2008.

How trends developed

Before we discuss the outsourcing decision, it is helpful to look back at how trends have developed. Going back several decades, the basic model was built on traditional asset managers and investment consultants. In the more challenging capital market environment that prevailed after 2000, and being aware of the success of alternative investment strategies in the 1990s and early 2000s, many institutions retooled their portfolios to include greater allocations to alternative investment strategies. That led to institutions retaining many more investment managers in the form of specialists focused on niche strategies. Many consultants found themselves under-resourced and ill-equipped to deal with this trend. If an investor's consultant had limited skills and experience, the institution had to figure out how best to execute on its own. This spawned specialized consultants focused on alternative investments as well as traditional consultants trying to broaden their capabilities into alternative investment strategies.

The manager of managers is another model that has existed for decades. Under this approach, the manager of managers aggregates client assets in funds for which the investment decisions are made by multiple external managers. This approach offers investors professional management and, more importantly, the benefit of diversification, either within an asset class or strategy or, even more broadly, at the portfolio level. This is particularly appealing to smaller investors. Another benefit is this model's usual cost effectiveness. With some exceptions, managers of managers do not consult on policy or strategy matters.

The next iteration heralded what we call "the new advisers," or the rise of the outsourced investment office. While consultants told investors what to do and investment managers provided product, the new advisers put the various components of the investment process together at the strategic level and added an overlay that looks at the portfolio

holistically rather than piece by piece. The new advisers operate as an extension of the institution to help it fulfill its mission.

Four models predominate

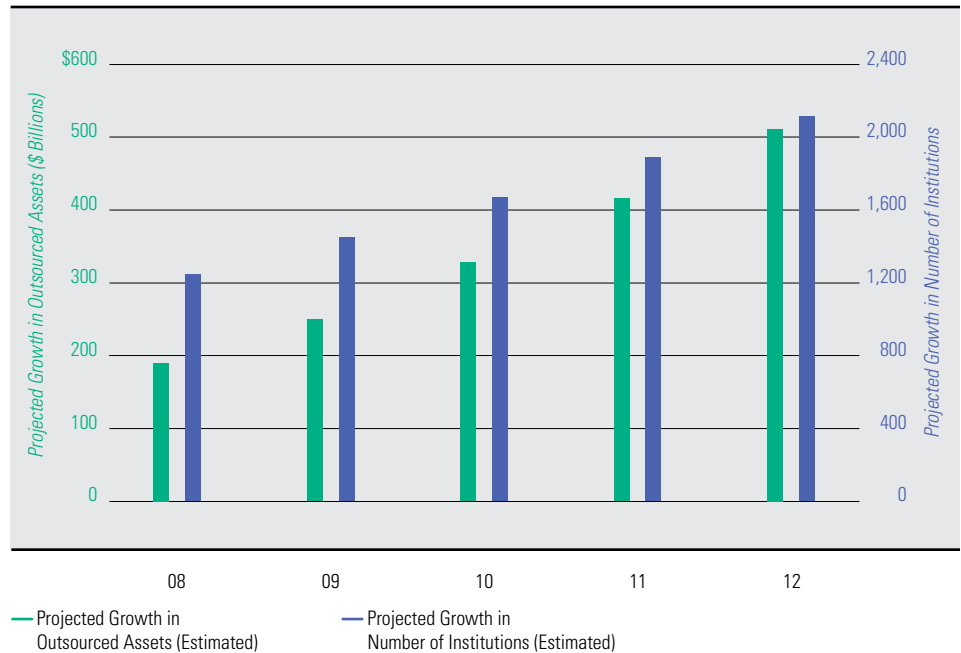
With that as a brief history, the focus turns to the models that are most prevalent today. Basically, there are four: consultants, global financial institutions/asset managers, multi-asset funds and the outsourced investment office. Let's look at each and then assess their respective pluses and minuses.

Traditional consultants advise on establishing and maintaining the investment policy—to include asset allocation, rebalancing and spending formulas—and screen investment managers from which the investment committee chooses to implement the policy. The investment committee thus owns the manager relationship as well as the managers' performance—not the consulting firm. Today, we are seeing a new form of consultant practicing what has been labeled "crossover consulting" or "implemented consulting." In this blended model, the consultant advises on policy matters but also selects the investment managers to implement the policy. A variable factor is the degree of discretion the consultant is granted; it runs the gamut, and the more discretion the consultant has the greater its accountability for performance.

The next model, that of global financial institutions or asset management firms, falls into two categories. The first consists of the global financial institutions and asset managers that offer a broad menu of investment products. These investment products are managed internally by proprietary investment teams. The second category consists of managers of managers. The manager of managers creates different investment funds—each of which consist of multiple managers with complementary and diversifying investment strategies.

U.S. INSTITUTIONAL INVESTMENTS—OUTSOURCING MARKET

2008–2012 (Estimated)



Source: Casey Quirk, *The New Gatekeepers: Winning Business Models for Investments Outsourcing*, December 2008

The multi-asset fund approach consists of providers that offer a single model portfolio—a one-size-fits-all philosophy. The client grants full discretion, so there is no input into the asset mix or to strategic or tactical shifts through time. The portfolio is diversified across multiple strategies, so although it is just a single fund it is well diversified.

The final approach is the outsourced investment office—which some call the "outsourced CIO"—in which providers put together a custom solution for each client based on individual needs, risk tolerances and return targets. This is a comprehensive approach that includes policy review and counsel, portfolio construction, ongoing investment management, rebalancing, due diligence and monitoring, risk management and reporting.

Weighing the merits

As investors seek to understand outsourcing today, it is important to consider the strengths and weaknesses of each model.

Typically, traditional consultants are good at the up-front phase of the investment process, such as advising on policy and formulating an asset allocation. They are usually not as good when it comes to implementation. Because they don't own the implementation, it can become an awkward dance between the consultant and the committee. The consultant provides advice, which the committee sometimes takes—or sometimes it does things its own way. Consultants are usually good at manager due diligence; they have good resources and can track manager processes, personnel and performance quite well. With respect to manager due diligence, however, there is the issue of selecting which clients get limited allocations to capacity-constrained managers. Consultants are generally challenged by risk management at the portfolio level because it is difficult to go from standard manager due diligence to aggregating position level data from multiple managers and quantitatively measuring portfolio risks on an ongoing basis. They also have to work with multiple client custodians, so there may be no unified approach to this important phase of risk management.

The traditional asset managers and big investment banks are very much oriented to investment products. They are typically strong when it comes to implementation. But, they are not as adept at the up-front work of helping clients understand policy issues. Large mutual fund companies and investment managers do not undertake manager search and due diligence because they want clients to use their in-house investment teams and products. They tend to be good at risk management at their individual fund level, but this doesn't always translate up to the client portfolio as a whole.

The multi-asset platforms don't customize strategies for individual clients; the sole decision the investment committee makes is whether to hire a firm of this type. There is no flexibility to develop asset allocation policies to meet individual institutions' objectives. In many cases, there are limitations on the timing and amount of

distributions. If the strategy fits what a client wants, this can be a good choice. However, if there is a mismatch between the fund's terms and the needs of the institution, then the multi-asset fund approach can be frustrating and problematic. The multi-asset class platforms are good at implementing their investment strategies, and they typically have access to great managers. They have a history of managing total portfolios, which helps with risk management. However, their approach can be dilutive to existing investors. For example, investments in limited private programs move to a lower allocation when new investors come into the fund.

The outsourced investment office model is the most flexible, in our opinion. Recognizing that this is the model that Commonfund offers, we want to be up-front about our bias. Nevertheless, it is possible to look at the category generically and remain objective. In doing so, we see that this class of provider works closely with clients to define strategy. These providers usually

have resources to be able to implement the strategy; manager search and due diligence are well established; and risk management is robust.

Conclusion

Asset size is no longer the determining factor driving the outsourcing decision. Other important factors such as fiduciary responsibilities, policy development, risk management, and operational support have become important components of the outsourcing decision in addition to portfolio construction and investment performance. Several outsourcing models have developed, and each has its strengths and weaknesses. Trustees and staff should give thoughtful consideration to their organization's objectives and resources in order to determine which outsourcing model may be most appropriate for them. |

SELECTING A MODEL

So, how do you decide which model is most appropriate? One way to answer the question is to ask a series of questions about your investment committee and staff.

Questions for investment committee

- What is our knowledge and experience?
- How much discretion do we want to keep? Who owns the decisions? Do we want to focus on policy and mission or do we want to pick managers?
- How much flexibility and influence do we want to have?
- How much diversification do we want in the portfolio? Basic equity and fixed income, or a wider range of asset classes and strategies? How do we feel about active and passive management?
- How quickly do we want decisions implemented?
- And how much transparency and risk management do we require?

Questions for staff

- How complex is the portfolio? How frequently is it rebalanced? Do we have to manage capital calls, distributions, limited redemptions and investment dates? Do we implement tactical over- and underweight decisions?
- How complex are the gift restrictions and spending?
- What level of resources can staff dedicate to investments? How many full-time employees are there? What is their expertise and experience? Are resources available for technology and analytical/reporting tools?