Once an institution decides to pursue the outsourced CIO or investment office option, it usually leads to the creation of a request for proposal, or RFP. Considering that the outsourced model is a strategic partnership with some degree of shared fiduciary responsibility and a greater degree of discretion, it is critical to research and ask the right questions during the evaluation process. Based on best practices of the outsourced service model, the following are some critical areas that should be taken into consideration and researched during the RFP process.

Interviewing providers and selection

In general, the RFP process should lead you to a short list of providers to interview—normally three to five. The one pitfall many get caught in is not being decisive in the specific governance model or type of provider they are looking for up-front, and thus they rely on the interview process as a way to educate the committee. Oftentimes, institutions will interview traditional consultants and the outsourced CIO provider together. This challenges the committee to make a very critical decision on which governance model to adopt while at the same time trying to select the right provider. Education should be done early so that the committee can focus on finding the right provider to meet the specific needs of the institution. Institutions should identify which criteria are most important to them and rank the criteria by importance, i.e., depth and breadth of investment expertise, alternatives expertise, risk management competence and capabilities, flexibility in investment choice, custom reporting capabilities, transparency, ability to provide training and education, level of dedication, service and support, performance and fees. This should be formulated in a scorecard format to help assist in the evaluation process.
Financial strength and commitment to outsourcing

Since the provider you will be choosing effectively will become an extension of your organization and assume a higher degree of fiduciary responsibility, it is critical to understand its financial resources. Some providers, like traditional investment consultants now offering an outsourced CIO service, come from a structure in which their margins had traditionally been very thin and the main principals often extracted most of the firm’s excess profits. These types of providers tend not to hold substantial reserves to support their business efforts. In addition, they might not possess the capital requirements to build out internal investment management, risk management and quantitative analytical teams as well as the infrastructure needed to support these initiatives.

Risk management

Having written extensively on this topic, Commonfund believes it is important to establish a fiduciary checklist to determine the level at which risk is being managed. It’s important for outsourced providers to describe the programs and procedures, including technology and software systems, they have established to monitor risk in client portfolios on an ongoing basis, as well as the ability to conduct risk management in real time. Some questions worth considering: Is there a dedicated and independent risk management team? How is risk management conducted across the firm; is it enterprise-wide? How do operations, legal and compliance initiate and conduct risk management? What level and frequency of transparency do providers offer, and which systems and applications do the investment and research teams employ to monitor and oversee security positions and counterparty risk? Are providers able to stress test and model portfolios in a real time setting or do they look through the rearview mirror?

Experience in alternative strategies

It is important to determine the level of investment expertise and dedicated resources (such as systems, analytics and teams) that outsourcing providers offer. It’s critical to determine if a provider has a handful of analysts who hold CFAs but lack actual investment management experience, or whether the provider has a long-tenured and deep team with extensive alternatives investment management experience spanning all strategies. Some providers do a great job of conducting high level due diligence but do not have the depth of investment management experience to truly understand the idiosyncratic nuances of complex positions used in the construction of alternative strategies and, more importantly, how these positions will impact the portfolio under specific market conditions. Some providers may not employ quantitative analytical teams or have in-house systems capable of closely monitoring the true exposures and volatilities within alternative strategies. Further, they may lack the ability to consolidate all underlying positions to truly quantify where concentrated risks lie in the total portfolio. Knowing what you own and having the expertise to understand complex alternative style strategies is critical for institutions that want to construct meaningful diversified portfolios.

Flexibility and independence

Institutions should ascertain the level of flexibility and independence providers have to determine the right fit for your institution. Some providers offer a one-size-fits-all approach, while some will offer the ability to fully customize a solution to meet the specific needs of an organization, whether for the full portfolio or a segmented mandate, such as alternatives. Providers often say they are independent or have completely open architecture, but when one digs deeper it becomes apparent that they work off a short list of managers or may be restricted to approved managers on their “platform.” Some providers may limit their due diligence to those managers who can meet the specific criteria for all their clients (high net worth, ERISA, nonprofit, etc.). In these cases, there are several challenges or potential conflicts that could arise. Capacity-constrained managers who are sought after pose a challenge. Either providers will avoid using these managers or have to prioritize which of their clients get access. Furthermore, very talented and well respected managers also will not lower their minimum account sizes or be forced to comply with specific reporting requirements just to be able to participate on an “approved list” or platform. Thus, in some cases, the field of managers is reduced by criteria that are more specific to how a provider runs its business than to what is truly best for their client’s portfolio. Institutions should look for providers that can construct portfolios using an array of high quality managers with a variety of structures to customize a program that is appropriately diversified and cost-effective.

Performance and long-term track record

With many new providers entering the outsourcing space, it’s crucial to evaluate their track records and determine how much discretion they exercised. Some providers may have limited experience in managing in a fully discretionary arrangement and will often show performance based off model portfolios or will assemble a hypothetical portfolio of “approved” managers. It’s important to compare apples with apples. It is also important to evaluate how well a provider manages portfolios under specific risk and return guidelines; therefore, it is essential to request all performance history on discretionary accounts. Performance should be representative of actual discretionary portfolios, not just hypothetical or model portfolios, and be shown net of all fees, including advisory, manager, custodial, legal, transaction and reporting services.