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With Emergence of Outsourcing Structures, New Questions From Institutions Arise

More institutions are considering outsourced cio models during their investment consultant searches as part of a growing trend for funds to farm out discretion on investment manager changes to outside firms.

But while the outsourced model has created more investment oversight options for institutions, it has also ushered in an extra layer of complexity in evaluating the most appropriate asset management structure, and thus a new set of questions that institutions must ask themselves when assessing firms.

When the Connecticut Health Foundation's investment committee recently came to the decision to select Cambridge Associates as its new outsourced cio, replacing a more "traditional" approach of meeting quarterly and hearing recommendations from investment advisor Evaluation Associates, they never realized how difficult a process it would turn out to be, said Carol Pollack, v.p. of finance and operations for the foundation.

"It was a challenging process at times. There is a lot of language and jargon specific to the investment world," Pollack said, explaining that the word "discretionary" tended to have different meanings for the firms it was reviewing and that a great deal of time was dedicated to ensuring questions were answered appropriately to garner the best understanding of each of their respective services.

What the foundation experienced is the reality that there are many facets to outsourcing, Pollack said, which include having complete discretion over the hiring and firing of managers, while other firms must still have decisions approved by a governing board before investment changes are made. Among the other options are "model portfolios" offered by firms such as Makena Capital Management and Investure.

In the case of Cambridge Associates, Director of Marketing Deirdre Nectow said that the firm adopts a model that creates an investment office for the client, appointing a cio from its staff of managing directors and senior consultants, as well as additional consulting, research and operations professionals.

"We're providing an investment office to our client, but the office just resides in Cambridge's office instead of the client's office," she said. "It's a little different because it's a custom team providing custom advice since we don't have a model portfolio."

Then there are institutions that only outsource a portion of their portfolios. Oberlin College, for example, elected to outsource the oversight and selection of managers in its alternatives portfolio to investment firm Cliffwater, while the equities and fixed-income assets were still overseen by an in-house staff led by CIO Marcia Miller.

Even after identifying the structure they desired, one in which discretion on tactical investment manager changes were given to a third party, what the Connecticut Health Foundation did not realize is how difficult it would be to assess the capabilities of one firm against another, adding to an already multi-month process.

"The other time consuming thing, which is still not done, is the shift from a traditional investment advisory role with the committee to one of a more strategic policy-setting role," said Harold Rives, treasurer of the foundation's board of directors, during an interview in July. "It's making sure that the cio takes charge and follows that strategic policy direction, and we're spending a lot of time making sure the investment policy statement that we consider critical is exactly the way we want it and gets approved by the board."

As a result of what became both a lengthy and informational process, the organization created a blog post on its Web site identifying some of the questions and concerns that other institutions should keep in mind when going through their own evaluation of prospective firms.

In the post (http://www.cthealth.org/blog/3-tips-for-selecting-a-chief-investment-officer), the foundation said that when going through the process, institutions should consider developing a comprehensive list of functions that the candidates will perform, extract comparable data on the firms being considered and make sure that everyone is on the same page when it comes to the concept of fiduciary responsibility.

Thomas Heck, cio of the Ball State University Foundation, said that one of the big defining issues of the process that ultimately led his fund to outsource the portfolio management to Perella Weinberg Partners earlier this year is making sure that they select a non-conflicted, independent firm that has "skin in the game" and will be compensated for performance, much like an asset management firm.

Overall, Heck said he and the investment committee were largely focused on the investment process of the firms they evaluated. Candidates were initially questioned on their investment philosophies and how they were able to articulate them to the board. After that, the committee asked firms what they did during the last three years of the market decline and how they were able to express their philosophy during that time. In addition, Heck said he asked firms about their actions on the day of the flash crash and after the tsunami in Japan.

"It was a very interesting process to take the committee through, considering where their background and bias was and bringing them to a point of a common understanding and goal," he said.

Ultimately, the two funds decided to go the outsourced cio route for different reasons. The Connecticut Health Foundation realized that a majority of Pollack's time was being spent on monitoring the organization's investments. So rather than hire a full-time cio, they felt an outsourced structure would allow Pollack to focus more time on her numerous other financial responsibilities, while spending less money on fees than they would have on compensating an investment professional.

Already possessing a cio in Heck, Ball State made their decision based on Perella Weinberg's ability to complement his role while allowing the fund's investment committee to focus on the development and execution of its investment policies.

Deciding Against the Outsourced Model

However, some institutions have gone in the opposite direction, electing to hire an in-house investment officer to oversee their portfolio, basing their decision, among other reasons, on an ever-growing asset base being fueled by a capital campaign or large donation.

John Lordan, senior v.p. and treasurer at Fordham University, said that while an outsourced cio structure was discussed among the members of the Bronx, N.Y.-based school's investment committee, they saw value in having a full-time staff member on campus, which is why they appointed Eric Wood as their first cio earlier this year.

"I think we did give an outsourced cio structure some consideration," Lordan said. "Ultimately, we felt that we had enough expertise on the board and as far as implementation, that's what Eric could do. We have the full time attention of a key person, which means more to us than a part-time service, although [the investment committee] has done a great job."

Leonard Raley, president of the University System of Maryland Foundation, said that the investment committee's decision to seek a new cio just made sense based on the size of its assets (approximately $761 million) and the foundation's location in the Washington, D.C. metro area.

"In our case, we have about 17 clients we serve, and having an in-house staff would enable someone with hands on the wheel," he said. "During these economic times, to financially manage the amount we budget, we want to know this individual wakes up every day thinking about managing our portfolio."

Kirk Jewell, president of the Oklahoma State University Foundation, echoed Lordan's views, saying that his investment committee's dedication to the portfolio was more than enough to hire Ryan Tidwell in March as director of investments and as the day-to-day liaison between the committee, it's investment consultant and the investment managers in the portfolio.

"Most of the outsourced cios I'm aware of take complete discretion of hiring/firing of managers, but our investment committee has served us well and we're not going to disengage the investment committee out of the process as long as we have investment committee volunteers," he said. "An outsourced cio is certainly something we looked at, but we didn't want to turn complete control to a third party. Would we consider it one day? Would we consider doing something better than what we're doing now? Sure."

Where Managers Fit In

Edward Berman, head of institutional fiduciary services at Neuberger Berman, said that from his standpoint as a firm that has been evaluated for an outsourced cio mandate, there are numerous pieces that must fit into place to create a successful relationship.

"Even before a client or board or committee member writes down what factors to consider, they need to start by considering what they want and who they are," he said.

Berman said that because it is not only investment management responsibilities that can be outsourced to outside firms, the ability of boards to define their own issues and needs is crucial to the process of selecting an appropriate model.

He said there are underlying factors beneath those issues, including how asset allocation and manager selections are made, what are the firm's processes and maybe most importantly, the level of fiduciary responsibility the firm takes.

"Institutions should understand the fiduciary standard that they're held to," Berman said.

Based on the experiences of the Connecticut Health Foundation and Ball State, institutions appeared to have come a long way in terms of maintaining a clear focus when assessing potential outsourced providers, but after all is said and done, knowing where investment managers will stand before and after the transition is significant to a smooth process.

In the case of the Hampton Roads Community Foundation, many of its investment managers recommended by its general investment consultant, Hammond Associates, are being used by its new outsourced provider, the University of Richmond's Spider Management Company, said Angelica Light, president and ceo of the foundation.

"Much of the portfolio has transitioned that was liquid, and we're now in the process of transferring what we can from the illiquid portfolio," Light said in July. "Many of our alternatives managers are also managers for Spider, so those assignments have been very easy."

For niche investment managers, discretionary investment models could usher in more mandates versus a traditional consulting structure, Nectow said, but that overall the models are essentially the same at Cambridge.

"The recommendations are from the same research infrastructure of over 100 folks doing manager research. They're making recommendations whether the client is discretionary or non-discretionary," she said. "What can vary is the acceptance of advice. If we like a niche manager that has certain risk characteristics that fits with a discretionary client's goals, we have an opportunity to put it in a discretionary portfolio without the client's permission."

"That being said, sometimes in a traditional consulting relationship, investment committees bring great ideas to us, we carefully vet the idea, and we put it in a non-discretionary portfolio," she added.