

# Bolstering Governance with an Outsourced CIO

By Steven F. Charlton, CFA\*

Fiduciaries seeking to ensure sound governance for their investment programs are increasingly outsourcing a substantial portion of their responsibilities to third parties with expertise in fund management and administration. Enter the outsourced chief investment officer, or OCIO.

Fiduciaries have a raft of obligations to the investment plans they oversee, on top of other roles and responsibilities. In addition, investment committees often comprise individuals who are not full-time investment professionals, and those that are may not fully understand the scope of their responsibilities. As a result, governance of an investment program may be overlooked or neglected. Robust governance ensures the effective implementation of sound procedures and processes and protects fiduciaries when investment performance falls short of expectations. To this end, outsourcing to a discretionary investment manager or OCIO can help govern investment programs adequately and effectively.

Certain fiduciary functions remain with the named fiduciaries, as defined by ERISA Section 402(a)(2). One vital function is the fiduciary's overall responsibility to prudently hire and monitor the OCIO or discretionary investment manager. This includes periodically reviewing the OCIO's performance, capabilities, systems and staff, and fees charged relative to the services rendered. Outsourcing is not a short-cut, but fiduciaries can alleviate many of their fiduciary duties as they relate to investment of portfolio assets through the selection of an appropriate OCIO.

## The Importance of Effective Governance

Good governance of an investment program defines and measures the processes and decisions of the organization's fiduciaries.

This includes the actions taken by fiduciaries and the fiduciaries' ability to act and grant power to act to others. Governance also includes the verification of the performance of decisions, whether made directly by the fiduciaries or by those acting through the express consent of the named fiduciaries.

The list below highlights many fiduciary tasks; it is not exhaustive. Governance covers all aspects of managing an investment program, including the following:

- Identifying fiduciaries responsible for certain activities
- Establishing appropriate goals and objectives and periodic review thereafter
- Establishing and maintaining an investment policy statement
- Ensuring prudent decisions are made and well-documented
- Determining and maintaining asset allocation consistent with goals and objectives
- Selecting and unselecting investment managers, advisors, and administrative service providers
- Ensuring fees paid for services rendered are reasonable, including all fiduciary activities such as investment management, advisory, and administrative
- Ongoing monitoring of all fiduciaries, including directed and discretionary fiduciaries
- Establishing and maintaining a funding policy (for ERISA plans)
- Ensuring regulatory filings are accurate and submitted in a timely manner
- Managing real and potential conflicts, including relationships among vendors, investment managers, committee members, and prohibited transactions

Governance does not imply good investment performance. Good governance is

relative and subject to interpretation, but liability associated with poor or inappropriate governance is well-documented. OCIOs can help mitigate potential liability for named fiduciaries (among the other potential benefits of investment outsourcing).

## Picking an OCIO That's Right for You

OCIO firms provide a broad array of products and services. Most offer daily oversight of an investment program, including allocating assets—either opportunistically or simply rebalancing—and the selection and administrative work that go into hiring investment managers. They also come in all shapes and sizes. At NEPC, we broadly categorize the three major types of OCIO firms.<sup>1</sup> The following are the three main categories of products and solutions available in the marketplace:

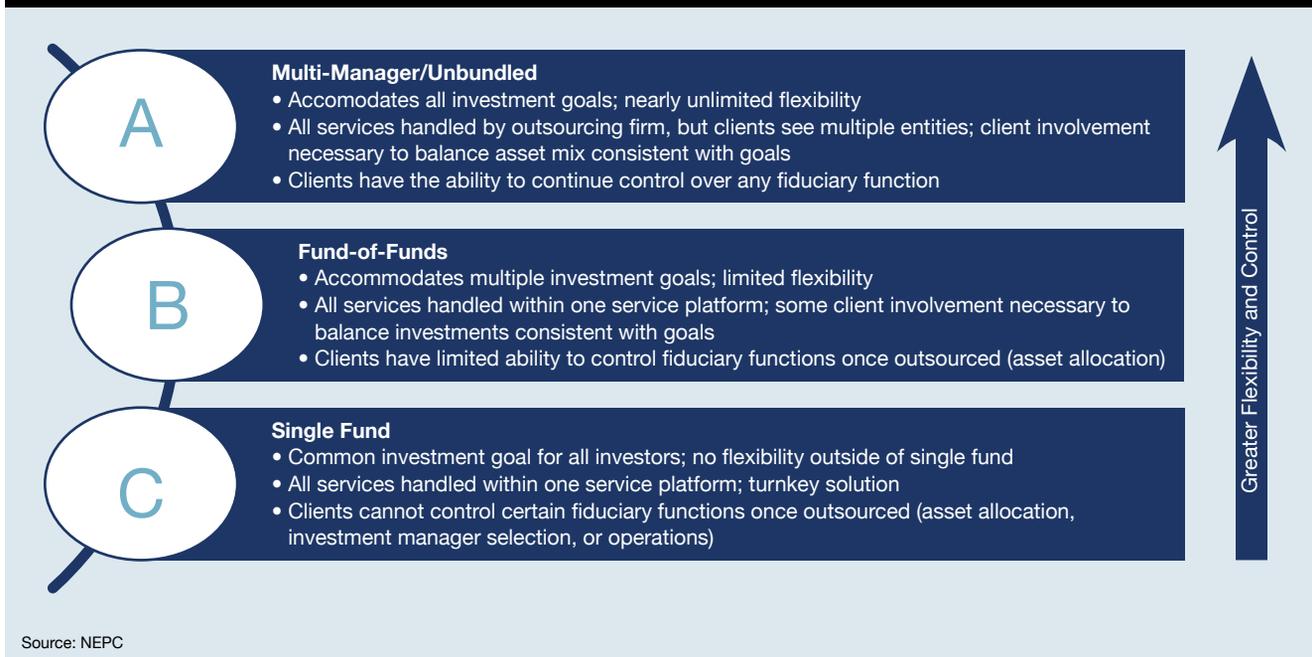
- Multi-manager/unbundled solutions
- Fund-of-fund products
- Single-fund products

Figure 1 summarizes the three categories, with the advantages and disadvantages of each.

Fiduciaries looking to outsource to a discretionary investment manager should first determine which OCIO structure best fits their needs and then conduct thorough due diligence to evaluate the potential providers. If you are starting with an advisory relationship, simply converting your existing relationship to a discretionary OCIO may not meet your fiduciary duties. Investment committees should solicit competing proposals to evaluate the landscape.

Regulators and potential litigants will want to know how you evaluated and selected your OCIO. This includes an examination

Figure 1: Three Types of OCIO Firms



of services, benefits, and associated fees. As with any fiduciary decision, the process and decision making should be well-documented with supporting materials.

Once fiduciaries narrow their focus to one or two of the categories above, the list of what they should look for as they evaluate potential OCIOs is potentially long given the importance of the decision. It also depends on what is being outsourced. For example, the ability of the OCIO to determine asset allocation may not seem to matter if your investment committee decides to maintain control of this duty. Still, your investment committee will rely heavily on the OCIO's capabilities to provide advice on asset allocation and evaluate appropriate investment strategies within the context of an approved asset allocation decision. Therefore, certain key capabilities should be examined as part of any OCIO search.

Good governance dictates that some capabilities and criteria are more important than others in regard to your goals and objectives, so fiduciaries should prioritize criteria before selecting the most suitable OCIO. An OCIO's product or services should be assessed for strengths and weaknesses and evaluated relative to the fees

charged. The following is our top-10 checklist for this assessment:

1. **Performance.** Is performance in line with expectations and consistent through different market environments?
2. **Staying power.** Does the OCIO have the financial resources to be your long-term partner?
3. **Client expertise.** Does the OCIO have deep expertise managing assets similar to your investment pool?
4. **Stability of the investment team.** Has the management team been together for a reasonable period of time and is it stable?
5. **Resources.** Does the OCIO have the research capabilities to support its investment philosophy and client base, and provide service and communications consistent with your expectations?
6. **Investment decision making.** Are your goals and objectives consistent with the OCIO's investment philosophy and decision-making criteria?
7. **Risk management.** What capabilities does the OCIO have in place to manage and monitor portfolio risk?
8. **Conflict management.** Does the OCIO have strong policies in place to manage and mitigate existing and potential conflicts?

9. **Back office.** Does the OCIO have well-developed back-office capabilities that offer robust quality controls, security of client information, and minimal manual processing?
10. **Fees.** Are the OCIO's investment management fees reasonable relative to the services provided? Fees may include an OCIO fee, underlying investment manager fees, and custodial and legal fees. Are there hidden fees such as trading or fund management/service fees?

Good governance requires a deeper dive into each of the areas outlined in the top-10 points. Sound governance dictates a well thought-out evaluation process and periodic monitoring thereafter. This may be achieved by the internal resources at most organizations; however, a small but growing number of third parties can help fiduciaries navigate and document the evaluation and decision-making process when hiring an OCIO.

#### What Entails Good Governance as Fiduciaries Look to Outsource?

Fiduciaries can alleviate a substantial part of their fiduciary duties through outsourcing, but finding the appropriate OCIO requires thorough due diligence. Fiduciaries should pursue a prudent process that

evaluates all relevant aspects of the outsourcing firms and associated fees. This process should also contemplate whether it is prudent to outsource.

Fiduciaries should set goals and objectives to define the scope of responsibilities to be outsourced. Because not all fiduciaries are familiar with the concept of what can be outsourced and to whom, fiduciaries likely will benefit from introductory meetings with outsourcing firms to gain a better understanding of the pros and cons of outsourcing certain fiduciary functions.

As the decision committee becomes more familiar with the concept of outsourcing, plan documents also should be examined. This evaluation should determine whether the documents allow for outsourcing of any or most of the fiduciary functions. The plan documents may need to be revised if they are inconsistent with the desired outsourcing approach.

The plan documents also should be reviewed to ensure that plan assets are

being used appropriately. Most outsourcing firms will charge fees based on total investable assets of the investment program, and fiduciaries often want to use program assets to pay these fees. In some instances investment programs are prohibited from paying for certain services with program assets. If this is the case, the plan documents may need to be revised as needed.

Once the fiduciaries have established the desired form of outsourcing and the plan documents are revised, as necessary, it is then appropriate to send out a request for proposal (RFP) for a competitive evaluation of the candidates. We provided a summary list of areas to be assessed earlier in this article. Fiduciaries should ensure the documentation of the evaluation process and provide a competitive analysis that informs the final decision. Finally, the contract negotiated between the named fiduciary and the outsourcing firm should clearly spell out the items delegated and level of fiduciary duty for the appropriate parties.

### Conclusion

Outsourcing to a discretionary investment manager or OCIO can help govern your investment program more effectively. Certain fiduciary functions remain with the named fiduciary. It is the fiduciaries' responsibility to evaluate whether delegation of their responsibilities is judicious. Fiduciaries should exercise caution and due diligence in selecting an OCIO because this evaluation process and documentation will be examined by regulators and potential litigants. Fiduciaries are also responsible for monitoring the OCIO or discretionary manager; the OCIO's performance, capabilities, systems, and staff; and the fees charged relative to the services rendered. Fiduciaries must demonstrate effective governance through a well-documented selection process and on-going monitoring. Outsourcing provides no short-cuts, but an OCIO can help ease the responsibilities of a fiduciary and enhance governance. ●

*Steven F. Charlton, CFA<sup>®</sup>, is the head of NEPC's discretionary consulting service. He earned a BA in economics and English writing from St. Lawrence University. Contact him at [scharlton@nepc.com](mailto:scharlton@nepc.com).*

### Endnote

1. See NEPC (2014), Investment Outsourcing: Evolution of the Industry, Products and Solutions, [http://www.nepc.com/writable/research\\_articles/file/2014\\_08\\_investment\\_outsourcing.pdf](http://www.nepc.com/writable/research_articles/file/2014_08_investment_outsourcing.pdf).

### Important Disclosures:

The comments provided herein are a general market overview and do not constitute investment advice, are not predictive of any future market performance, are not provided as a sales or advertising communication, and do not represent an offer to sell or a solicitation of an offer to buy any security. Similarly, this information is not intended to provide specific advice, recommendations, or projected returns of any particular product, strategy, or program of NEPC, LLC (NEPC). The views presented herein represent the good faith views of NEPC as of the date of this communication and are subject to rapid change as economic and market conditions dictate. Though these views may be informed by information from sources that we believe to be accurate, we can make no representation as to the accuracy of such sources nor the adequacy and completeness of such information.

Please note that all investments carry some level of risk. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Additionally, past performance is no indication of future performance.

Please contact NEPC for current information about our views of the economy and the markets.



**CONTINUING EDUCATION**  
To take the CE quiz online, visit [www.IMCA.org](http://www.IMCA.org).