Maximizing the OCIO Growth Opportunity

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IN THIS ARTICLE

The rapidly evolving OCIO market has created new opportunities and risks for asset managers. We spoke with leading industry experts to help identify the best way for managers to make the most of this growing opportunity.

Outsourced Chief Investment Officer ("OCIO")-managed assets represent a large and compelling growth opportunity for investment managers today. OCIOs currently run a whopping $1.6 trillion of AUM — and with an expected 14% annual growth over the next five years — this should drive the market toward $3 trillion by 2022.

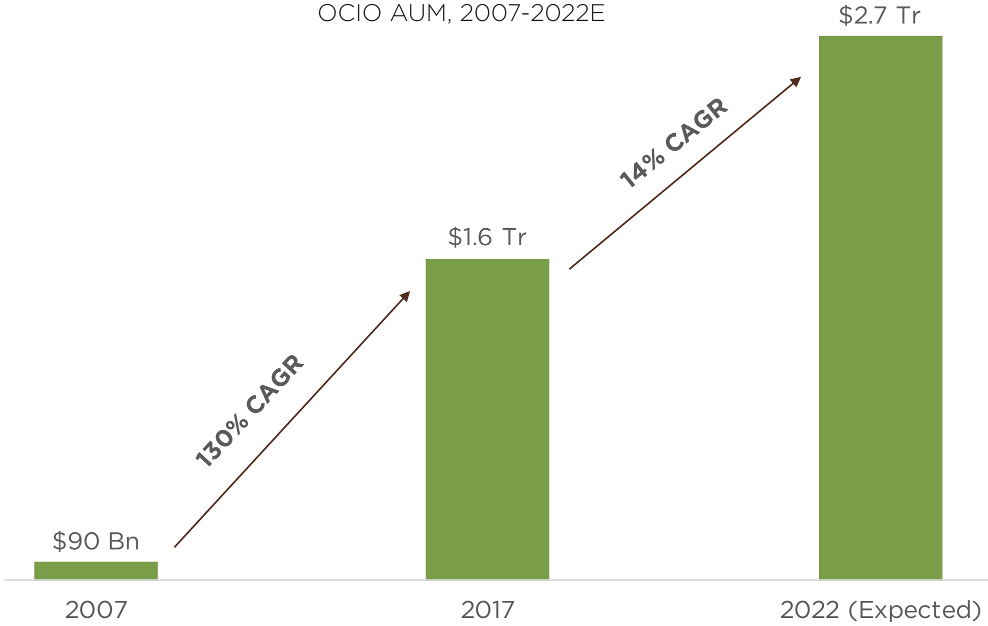
Winning and retaining OCIO assets requires a different approach than asset managers have used in the past. This article outlines steps managers should take to maximize the OCIO growth opportunity for their firms.

Asset managers face unique risks from OCIO-managed mandates, many of which are not yet broadly known or understood. In this article, we identify potential risks managers should consider when entering into an OCIO partnership.

Chestnut Advisory Group provides business development consulting to asset managers. Chestnut helps managers raise and retain capital by providing custom go-to-market strategies and content.

The Substantial and Growing OCIO Market

OCIO AUM, 2007-2022E



Source: Pensions and Investments, Cerulli Associates

Maximizing the OCIO Growth Opportunity

Asset managers are facing new opportunities — and risks — created by the rapidly evolving OCIO market. OCIOs are now effectively a new distribution channel for asset managers. We spoke with leading industry experts to help us identify the best way for managers to make the most of this growing opportunity.

OCIO-Managed Assets: A Large and Growing Market

Over the last 10 years, outsourced discretionary management of institutional assets has grown by an explosive 130% CAGR, reaching just over $1.5 trillion in AUM by the end of 2017.[1] Back in 2007, only 479 institutional investors engaged OCIOs with full discretion; that number exceeds 11,000 today.

The rapid growth of OCIO-managed assets is not abating. This market is expected to expand by another $1.1 trillion over the next five years, reaching $2.7 trillion in 2022.[2] In the last year alone, we saw a $364 billion jump — just over 21% growth.[3]

Cost Savings are NOT the Primary Driver of OCIO Demand

There are a wide variety of reasons behind the rush of plan sponsors choosing to hire an OCIO, but saving costs — and by implication, paying lower manager fees — is the least of these. Rather, institutions are searching for increased and better qualified resources to manage what they view as an increasingly complex investment marketplace.

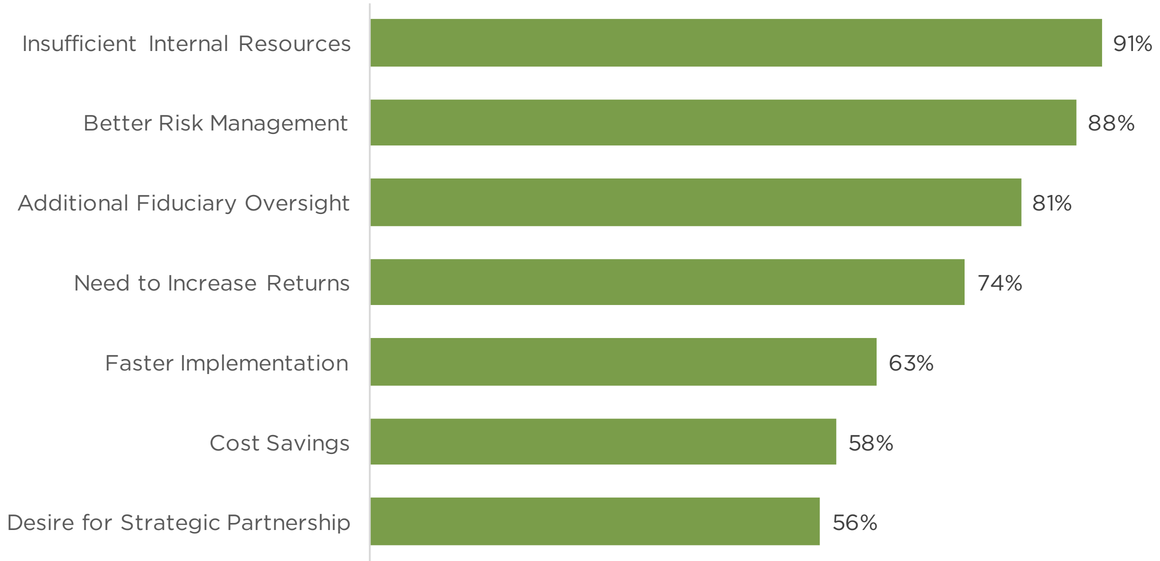
> "Cost savings alone are not a good reason to go the OCIO route. In fact, institutions tell us that in most cases there is a net cost increase after hiring an OCIO. Generally, the institution's staff is not cut when an OCIO is hired." - *OCIO Search Manager*

Understanding Today's OCIO Provider Landscape

As the OCIO business has grown to about 74 firms today, it has attracted many new entrants with a slew of different business models.[4]

Factors Driving Plans' OCIO Hiring Decision

Ranked by Importance



Source: Chief Investment Officer Magazine

Traditional Investment Consultants

Traditional investment consultants' OCIO business is currently the largest piece of this market. The OCIO business is a natural outgrowth from traditional investment consulting. OCIO services generate higher fees while levering the same central resources of manager research and core competencies of asset allocation and manager selection. Traditional investment consultants also have existing client relationships, so moving to an OCIO service is often an easy transition for the client.

The OCIO business is attractive for consultants, as the fees are often 2-3x more than a non-discretionary client, and much of the work is the same. All consultants aim to lever their existing manager and macro research to bring "best of breed" to their OCIO clients. While many provide a consistent set of recommendations for their clients, some offer full customization via dedicated teams that each work with a small group of clients. In cases like this, the OCIO client team may spend as much as half of their time on manager research to augment the efforts of their dedicated centralized research team.

Conflict Risk at Traditional Consultant OCIOs

The fact that traditional consulting firms offer discretionary and non-discretionary services to the same client market opens them up to a unique potential perception of conflict. This is a risk managers must be aware of and continually monitor.

As the OCIO market grows, governmental regulators are taking notice and stepping up their interest in potentially regulating this new service. For example, last fall, the UK Financial Conduct Authority (FCA) announced that the Competition Market Authority (CMA) will be investigating investment consultant firms with OCIO businesses. Previously, the FCA asked the British government to give it more regulatory control over the investment consultant market. Historically the US and other major governments follow each other's oversight efforts, particularly when there is a finding (or implication) of impropriety.

In this case, the UK authorities are concerned with a lack of transparency with consultant firms that offer OCIO services. The investigation is expected to run through March 2019 and similar US investigations by the SEC and regulations may follow. Examples of the types of potential conflicts being investigated are:

Largest Investment Consultant OCIO Providers
OCIO-Only AUM, 2017

Consultant	AUM
Mercer	$191 Bn
Russell	$124 Bn
Aon Hewitt	$104 Bn
Willis Towers Watson	$88 Bn
Alan Biller and Associates	$38 Bn
Callan Associates	$24 Bn
Cambridge Associates	$22 Bn

Source: Charles Skorina & Company, most firms as of 6/30/17

- **Special treatment of some clients** if they are also involved with the consultant's other lines of business**.**
- **The practice of "double-dipping",** charging an additional layer of fees in co-branded funds used for OCIO clients' portfolios.
- **Providing special treatment to managers** who pay fees to consulting firms for educational services, such as to attend conferences run by consulting firms — or "pay-to-play". This could potentially be extended to include managers who agree to special discounted fee structures with certain consultants in order to be included in OCIO and other proprietary comingled consultant funds.
- **OCIOs with proprietary funds may have financial incentive** to invest clients in these funds to earn more fees if, for example, the fund includes performance incentives or management fees. Some OCIOs rebate these fees back to their clients while others do not.

Another key potential conflict for consultants with OCIO businesses is client allocation to limited capacity products. For example, a consulting firm receives a $250 million allocation to a new private equity fund from a well-reputed manager. How does the consultant allocate that opportunity among its higher-fee OCIO clients and its lower-fee traditional consulting clients?

We have heard examples of some consultants solving this issue by providing their entire client list to the GP at the private equity fund. At this point, the PE fund may be incented to select clients where they will only have to interact with one representative decision maker, rather than a time-intensive team.

We believe it is extremely important for managers entering into a partnership with a traditional consultant-based OCIO to be aware of these potential conflicts. Failure to do so could result in substantial reputational damage to any manager who is involved in any subsequent investigation. For example, one implication in any pay-to-play investigation would be that the manager isn't really best in class.

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Asset Manager OCIO Business Also Growing

Some asset managers — primarily the largest — now offer OCIO services themselves. Managers tend to call this business "solutions," running a spectrum from asset allocation products to full portfolio discretionary management of clients' portfolios across all asset classes. In many cases, these businesses grow out of the manager's endowments group.

Manager OCIOs Eat Their Own Cooking

Asset managers generally use in-house products either exclusively or primarily in their OCIO clients' portfolios. This approach limits the opportunity for outside managers to access these assets. Nonetheless, not all asset managers offer all asset classes via their OCIO business, so the asset manager OCIO segment can be an attractive market for some managers, particularly in the alternatives space.

Other Large OCIO Providers

The third group of large OCIO providers today can be classified into two buckets. The first consists of firms that have been dedicated solely to the OCIO business since their founding; many of these are focused primarily or exclusively on the endowment and foundation marketplace. The other bucket consists of one firm; SEI, the longstanding back and middle office service provider that has built a large and rapidly growing OCIO business.

Top Asset Manager OCIO Providers

OCIO-Only AUM, 2017

Asset Manager	AUM
Goldman Sachs	$126 Bn
BlackRock	$122 Bn
State Street	$84 Bn
Northern Trust	$65 Bn
Vanguard	$46 Bn
JP Morgan	$42 Bn
US Trust	$30 Bn
Wells Fargo	$23 Bn
PNC Bank	$22 Bn
Fidelity	$18 Bn
Agility	$8 Bn

Source: Charles Skorina & Company, most firms as of 6/30/17

For Success, Treat Non-Asset Manager OCIOs Like Consultant OCIOs

The strategies we recommend for managers seeking to partner with consultant-based OCIOs are applicable to the other OCIO firms such as those above. Firms that have been solely OCIO since founding operate full-time dedicated manager search efforts, and SEI also has a large central manager research team.

OCIO Fees Pose Opportunity and Risk for Managers

While OCIO services are all over the map, as you can imagine, fee levels and structures are as well and reflect the varying level of service. Typically, OCIO fees are in the range of 20-60bps, but can be higher and lower, depending on the service. The two most common OCIO fee structures are basis points based on AUM, or a flat dollar amount fee. The AUM-based structure incents the OCIO to grow the assets and ensures incentives are aligned with the institution.

Largest "Other" OCIO Providers

OCIO AUM, 2017

Firm	AUM	Background
SEI	$88 Bn	Back and middle office services, and OCIO
Strategic Investment Group	$25 Bn	Solely OCIO since founding
Commonfund	$24 Bn	OCIO for nonprofits
Hirtle Callaghan	$23 Bn	Solely OCIO since founding
Partners Capital	$20 Bn	Solely OCIO since founding
Makena	$19 Bn	Solely OCIO since founding; use pooled vehicles
Investure	$13 Bn	Solely OCIO since founding; nonprofit focus

Source: Charles Skorina & Company, most firms as of 6/30/17

Managers Should Enter OCIO Fee Agreements with Open Eyes

As we discussed earlier, a major piece of the UK regulatory inquiry into the consultant-based OCIO industry revolves around fee transparency. We expect any findings or rule changes will eventually impact all OCIO service providers.

Our major piece of advice to managers entering into partnerships with OCIOs is to **ensure the manager understands how their fee structure is or is not disclosed and charged to the end client.** In many cases, the OCIO negotiates a fee structure with each asset manager subject to a non-disclosure agreement keeping the manager fee with that OCIO confidential. While an NDA can feel very attractive at the beginning of the manager/OCIO relationship, as we have seen in other arenas material covered by non-disclosure agreements has a nasty habit of becoming public when there is a perceived newsworthy scandal.

The range of OCIO client fee structures includes:

- **One master fee** to the OCIO, which covers all services
- **Fee by comingled vehicle**
- **Bundled fee by asset class,** including SMAs
- **Full transparency -** OCIO fee separate from manager fee. The client pays manager fees directly to each manager. In these cases, often the OCIO aims to manage an all-in expense target.

Overseeing the OCIO: A Conundrum Solved by OCIO Search Consultants

Institutional investors are increasingly turning to OCIO search consultants to help them navigate the wide range of services and provider types in the marketplace today. Conducting thorough due diligence of OCIO candidates is critical. Most plan boards want an outside expert to validate the bidding OCIOs' abilities in effective trading, back office services, disaster recovery and other issues.

The Board Remains the Fiduciary Even with an OCIO

As the ultimate fiduciary responsibility remains with the institution even in an OCIO arrangement, we expect institutions will increasingly use OCIO search consultants to conduct additional oversight of their OCIOs.

Several OCIO search consultants told us they anticipate a new business will grow over the next 3-5 years: being retained as an expert third party to regularly monitor and review the OCIO service provided to institutions.

Driving from the Rear-View Mirror, 21st Century Style

When improving plan performance is a major motivator for the hiring of an OCIO, this has the risk of becoming the 21st Century version of the perennial institutional investor temptation to "drive via the rear-view mirror." Instead of firing recently underperforming managers and replacing them with

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Manager Best Practices for OCIO Firms

Invest More Resources in Your OCIO Effort

As the OCIO market grows, the demand on the manager's time grows as well. At a minimum, you, the manager, need to now cultivate a relationship with the CIO of the consultant's OCIO unit, in addition to existing efforts with the consultant's research arm (and, often, with field consultants too). Some of the larger consultant-based OCIOs have more than one CIO. Other consultant-based OCIOs have individual client managers conducting independent manager research. Successful asset managers will cultivate a relationship with each one of these important new decision makers.

Do Your Research

It is critical to research each OCIO firm before you approach it. You need to understand when a strategy or asset class is currently in or out of favor with that OCIO and not waste their time. OCIOs often prefer managers with very high conviction, high active share, distinctive strategic style and high concentration. To be successful raising and retaining consultant-based OCIO assets, managers should research and understand these preferences at each firm.

Focus on Your Best Products

For managers with more than one product, when approaching the OCIO side of a consulting firm, bring your best ideas and be flexible. The OCIO does not need to rate every product you offer. In addition, OCIOs tell us that a manager's ability to craft custom products is quite valuable.

Be Candid About Your Near-Term Outlook

Be sure to speak up when you feel it's the right (or wrong) market environment for your product's performance. This approach will help managers with all OCIO-managed assets, not just those managed by consultant-based firms. Helping the OCIO look good by giving them the heads up to cycle out of a certain product ahead of a rough patch will serve any manager extremely well in the long run with that OCIO relationship.

Manage Expectations Well — No Surprises

When a manager has news to deliver, particularly bad news, the earlier the better in order to build trust. Managers should expect a much more rapid OCIO response to any such news than on the traditional side, as OCIOs aim to be nimbler in their portfolio allocation decisions than the traditional approach. In the case of good news, this can lead to quicker new asset inflows as well.

Build and Deliver Great Intellectual Capital

An asset manager who provides a steady stream of outstanding thought leadership is hugely valuable to a consultant-based OCIO. As OCIOs serve as the sole conduit of all market and portfolio analysis to each client, and as consultant OCIOs do not actively invest in the market themselves, they rely on managers to provide real-time capital markets insight. These insights are used to help drive the OCIO's allocation decisions and for client communications.

Keep the Dialog Going

OCIOs are much more nimble in implementing asset allocation changes than traditionally consulted portfolios. A timely flow of information from asset managers to OCIOs is critical in order to ensure that when the OCIO is ready to move into a new strategy, they are ready to invest with you.

New OCIO Rules of Engagement

A manager cannot go directly to the client when there is an OCIO, unless the OCIO specifically requests it. OCIOs tell us they very rarely ask a manager to speak directly with a client; when they do, it is usually due to a period of underperformance.

Potential to Reallocate Manager Resources

Managers with large OCIO-related business could find a reduced need for resources in several key areas over time:

- **Client Support** – OCIO-managed assets only require one point of contact for the manager, meaning that many issues the manager formerly handled (such as cash flow requests, performance review discussions, RFP requests, one-off portfolio questions, tax statement generation) are now handled by the OCIO.
- **Endowment & Foundation Efforts** –The non-profit market was among the earliest adopters of the OCIO model, and the trend continues to be robust. As a result, the opportunity for direct asset manager marketing to this segment may decrease over time.

(Continued from p.5)

managers who have outperformed over the past 3-5 years, thus selling low and buying high, plans may now be tempted to replace “underperforming” OCIOs with “outperforming” OCIOs over time.

Clear OCIO Communications are Crucial

A major factor OCIO search consultants consider is how well the OCIO will service its client. One search consultant told us he has found that many OCIOs oversell their client service and for that reason end up getting replaced.

One key factor for managers to keep in mind is that their content and ability to explain the portfolio investment decision process is crucial, as this communication must be clearly translated and conveyed by the OCIO on the ultimate client. The better the manager’s original communication and the clearer the story, the easier it will be for a partner OCIO to translate to their clients, helping asset raising and retention.

> “We prefer that managers take the effort that would normally go into direct client service and instead have more frequent communication with us about any changes in their approach and their market views.”
>
> *-OCIO*

New Board Chair Common OCIO Search Precursor

Another frequent catalyst for an institution to move to OCIO is a new chair of the board coming in, whether from the outside or internal. When a manager learns of a new board chair at a client, we recommend the manager try to use their influence to introduce any strong OCIO partners to relevant board members. Such an approach can help improve the relationship with the manager’s OCIO partners and increase the odds that the manager maintains a mandate with that plan.

**Manager/OCIO Partnerships:
Summary Opportunities and Risks for the Asset Manager**

Factor	Opportunities	Risks
Additional revenues	• Earn management fees on AUM from investors and market segments otherwise unlikely to hire manager directly • Potential to earn revenues more rapidly than simply via traditional internal distribution efforts	• Potential fee compression, as OCIOs tout ability to lever their scale to achieve fee discounts • Business concentration risk • Commit excess capacity at a discount rate, potentially for a long time
Faster capital flows	• As OCIOs can be nimble in their asset allocation decisions, winning mandate decisions will occur more quickly than in traditional institutional accounts.	• Tactical reallocations will be more rapid, as will terminations for various reasons
OCIO partnerships link reputations	• Managers can benefit from the “halo effect” of a strong partnership with a highly respected OCIO, implying the manager meets that OCIO’s extremely high standards	• Should the OCIO pull capital from the manager for any reason, the manager may find itself needing to explain these outflows to all other constituents • Any negative issue at a partner OCIO, such as an accusation of bias or conflict — valid or not — would require immediate defensive explanation by the manager, if not a revisiting of the partnership itself
OCIOs disintermediate managers from end clients	• Managers use less client support resources, from relationship and account management to due diligence requests	• Managers need more resources to properly service each OCIO • Managers must ensure the OCIO truly understands all developments at the firm and in the portfolios
OCIOs are much more willing to invest in custom strategies	• Potential to work closely with OCIO and structure custom strategies for their client base	• Managers should attempt to ensure any custom strategy can be sold to non-exclusive OCIO clients; if not, must ensure OCIO fees are appropriate
Some OCIOs are willing to invest in newer managers	• Its mutually beneficial for an OCIO firm to engage with good quality managers early in their lifecycle. This enables the OCIOs (usually boutiques do this) to secure more capacity for themselves and deliver good performance to their clients while also usually getting a fee discount for being a first mover.	• Business concentration risk can quickly become a catch-22 for new managers

Thank You

We would like to thank everyone at the following firms who took the time to speak with us during the course of our research for this article:

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Manager Analysis

SEI Investments Company

Strategic Investment Group

Vanguard

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