Strategic Investment Group®

Fiduciary Insights

TAKE CONTROL THROUGH OUTSOURCING

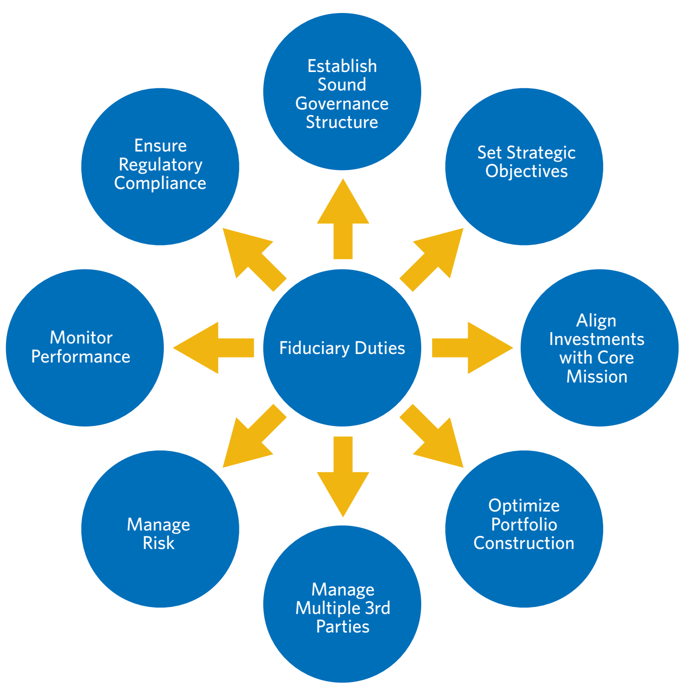
THIS EDITION OF FIDUCIARY INSIGHTS HIGHLIGHTS THE MANY WAYS IN WHICH AN OUTSOURCED CIO CAN HELP OVERSTRETCHED AND UNDER-RESOURCED FIDUCIARIES SHOULDER THEIR COMPLEX RESPONSIBILITIES AND SETS OUT THE KEY PRINCIPLES THAT SHOULD GUIDE FIDUCIARIES IN STRUCTURING A CIO OUTSOURCING ARRANGEMENT.

Introduction

Many institutions rely on one or more large pools of investments to support their operations. These investments are integral to the institution's financial well-being, representing in some cases a large share of total assets, but investment management is seldom an integral part of the institution's core mission and operations.

Stewards of these institutional pools of investments shoulder a wide range of complex responsibilities. Rarely, if ever, however, are adequate resources available internally to manage investments effectively. Adequately staffing and equipping an investment office is particularly difficult when the core mission is far removed from the world of investments.

FIGURE 1:
A single partner co-fiduciary with deep resources can help address the full range of complex investment challenges.



Fiduciaries can take control of the strategic direction of their investments and ensure their alignment with core operations by seeking an outsourced co-fiduciary partner.

Traditional Fiduciary Governance Model

A typical response to the lack of adequate internal resources is to form relationships with a wide range of third party providers, each having a narrowly focused objective, but little insight into the full picture of how the total portfolio is structured and the role it plays in the core operations and broader financial structure of the institution. Under resourced fiduciaries are often overwhelmed by the day-to-day management of their investments.

In this model, investment committees spend a disproportionate amount of time and energy focused on hiring, firing, and supervising a plethora of individual managers, and reacting to short-term portfolio movements. Approaching the task in this way, fiduciaries are led to make piecemeal judgments based on a partial perspective, with little reference to managing the range of underlying risk exposures in the total portfolio and even less attention to the role of investments in the institution.

Following this model leaves little room for fiduciaries to fulfill their chief responsibility: to set an investment strategy that is fully aligned with the institution's core mission and its ability to bear risk. Fiduciaries following this model risk losing control by allowing the cumulative impact of individual decisions taken in isolation to trump a long-term strategic perspective.

Fiduciaries can retake control of the strategic direction of their investments and ensure their alignment with core operations by seeking an outsourced co-fiduciary partner. A strong partner acting as a co-fiduciary with discretion to implement agreed upon investment policies streamlines and strengthens investment governance, complements internal resources, and allows fiduciary bodies to reorient their focus on strategic issues. A well-structured CIO outsourcing arrangement with the right partner addresses the many pitfalls of the traditional fiduciary governance model.

What is CIO Outsourcing?

There are many names to describe the co-fiduciary partnering model that we have in mind. These include outsourced CIO (OCIO), fiduciary management, total investment governance solutions, delegated CIO, and integrated portfolio solutions. Whatever the name, the aim is to ensure that the right resources are available to help shoulder complex fiduciary responsibilities. The key is to partner with a co-fiduciary dedicated to helping design and implement investment policies that are tailored to the institution's particular objectives, mission, willingness to bear risk, and changing circumstances. The ideal OCIO relationship is a nearly seamless extension of fiduciary bodies and internal staff, complementing them with the additional resources needed to steward their investments effectively.

Why Consider an Outsourced CIO?

Institutions consider an OCIO for a number of reasons. In many cases, the catalyst for seeking an OCIO solution is tied to changing organizational priorities, a new strategic direction, or dissatisfaction with the existing investment governance structure. Whatever the catalyst, institutions typically have one or more of the following four objectives when searching for an OCIO.

- **Enhance Performance Targets.** The ultimate aim for fiduciaries is to achieve their return objective at the least cost and with the minimum amount of risk. Since costs and volatility impose a drag on returns, controlling cost and minimizing risk are essential to the long-term accumulation of wealth. An OCIO can help construct a cost-efficient portfolio that strikes an optimal balance between risk and return. The analytical tools at the OCIO's disposal can also be used to align the balance struck between return and risk with the institution's circumstances and core mission. Improving net-of-fee, risk-adjusted returns will increase wealth over time and help investment portfolios grow with the growing demands placed on them.

- **Streamline Governance:** An OCIO increases the efficiency of decisionmaking, simplifies oversight, and helps appropriately focus the attention of each level of investment governance. By taking on the responsibility of the day-to-day management of the investment portfolio, the OCIO allows internal staff to focus on core operations, and governing bodies to focus on setting the institution's strategic direction and ensuring the alignment of the investment policy with that direction. Governance is also enhanced by replacing the fragmented views provided under the traditional fiduciary governance model with the total perspective provided to fiduciaries by the OCIO.

- **Save Time and Cost.** CIO outsourcing eliminates the need to recruit and retain a fully staffed internal investment office and provide that office with the up-to-date systems needed for policy design, risk management, back-office operations, and performance measurement. An outsourced CIO also generates cost savings by improving the efficiency of the portfolio management process. Such efficiencies include an increased ability to negotiate lower manager fees, the elimination of fund-of-fund fees, and the reduction of other fees associated with third-party providers rendered superfluous by the OCIO.

- **Expand Resources.** Managing complex investment portfolios is rarely a core competency of institutions reliant on such portfolios to support their missions. The broad range of resources required for the task is not available in-house because it is neither cost-effective nor practical to build and maintain such an internal capacity. An OCIO provides the diverse resources and capabilities needed to manage complex investment portfolios. These resources include the capacity to model asset allocation strategies and their suitability; expertise in assessing and managing the full range of asset classes and related investment strategies; the capacity to implement complex investment strategies; rigorous risk management analytics; legal staff to negotiate and execute agreements with managers; robust systems to manage operations; back-office services, including accounting, cash-flow management, performance measurement, documentation, tax and audit support; and experience in managing relationships with other service providers, including managers and custodians.

A co-fiduciary can only be effective by firmly grounding the investments in the context of the total institution, and basing all investment decisions on the likelihood they will further the institution's core mission.

Key Criteria for Successful CIO Outsourcing

Choose the right partner

A true partner is one who will help shoulder the burden of accountability. An OCIO should be willing to take fiduciary responsibility and, in the case of ERISA portfolios, act in accordance with ERISA as a "Named Fiduciary." Choosing an external partner who acts as a co-fiduciary helps solidify the high degree of accountability that should underpin a CIO outsourcing relationship. A co-fiduciary must be committed to take on a duty of care to act with prudence, and a duty of loyalty to act in the best interests of the client. This marks a significant departure from the typical "consultant" model, in which advice is given without responsibility for the ultimate decision or accountability for the eventual outcome.

A prime motivation for outsourcing is to complement internal resources with the resources and experience of a strong external partner with a sound investment philosophy and process. The right partner will have a deep bench of experienced investment professionals, sophisticated analytical systems, and a strong ethos of service. Having such a partner will permit a client to exploit opportunities across all asset classes, take advantage of sophisticated strategies and investment techniques, and implement dynamic strategies, such as liability-driven investing, that adapt to changes in funding status.

Perhaps most critical of all, the right partner will place prime importance on understanding the *raison d'être* of the investments and their role in the institution. A co-fiduciary can only be effective by firmly grounding the investments in the context of the total institution, and basing all investment decisions on the likelihood they will further the institution's core mission. This perspective is essential for designing an investment policy that targets the right balance between return and risk.

Seek customized solutions

Since all institutions have unique missions, financial structures, and vulnerabilities, the right investment solution generally is one that is customized. Firms offering CIO outsourcing services should conform to the needs of the client, not the other way around. Turn-key solutions that offer a one-size-fits-all portfolio miss the main point and key potential benefit of outsourcing.

A co-fiduciary partner should aim to customize investment strategies to the mission and strategic direction of the institution. Assessments of the appropriate balance of risks to bear to achieve funding objectives should be grounded in the metrics used to monitor the institution's financial health by its fiduciaries, stakeholders, creditors, donors, and regulators. Developing a truly customized approach based on a deep understanding of how investments support and interact with the core mission is critical. Such a customized approach enhances fiduciary control and appropriately focuses fiduciaries on the critical responsibilities of setting strategy and ensuring the alignment of investments with the institution's needs.

Take a comprehensive view of risk

An institutional investment portfolio is typically a means to achieve a set of objectives, and not an end in itself. It exists in a financial context, and its purpose is to serve a broader mission. Too often, however, the link between investment portfolios and the institutional objectives that they are intended to serve is tenuous. Too little attention is given to explicitly assessing the interaction between investment performance and the broader mission and finances of the institution. Institutions often lack the resources and analytical tools needed to quantify the impact of a range of potential investment outcomes on the institution's financial well-being. As a result, investment strategies are frequently designed in relative isolation with an intuitive sense of the risks that they might impart to the institution, but little quantitative analysis to measure the impact of different investment outcomes on critical financial metrics.

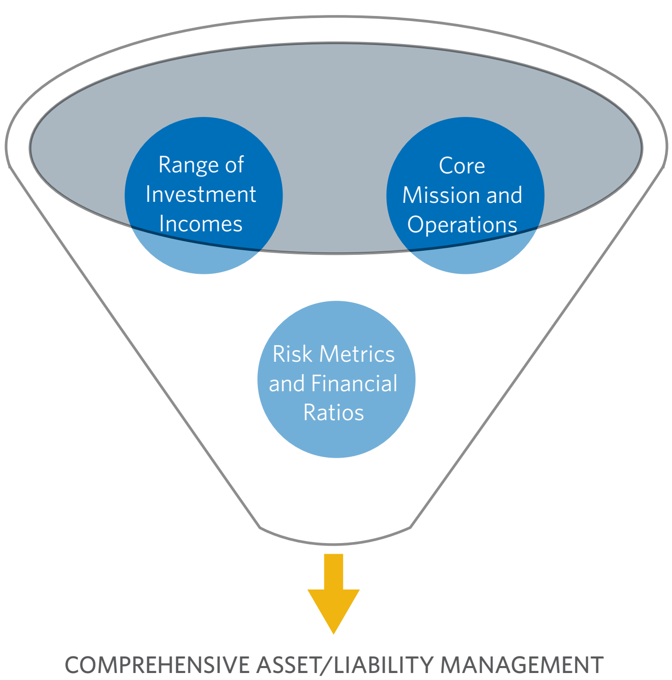
Outsourcing should provide the resources and analytical capabilities to undertake a comprehensive asset/liability management (CALM) analysis, as this is the best basis on which to design an appropriately customized investment strategy. The need for CALM analysis is especially great when an institution has multiple investment portfolios, each dedicated to a different purpose. Such institutions can easily fall into the trap of managing their various funds as separate silos, instead of viewing all of their asset risks and operational risks together.

A CALM approach provides a solution to this problem. It simulates investment returns across all portfolios using various methods to develop probability distributions of returns under a range of scenarios. These aggregate return probabilities are then integrated with projections of operating results, capital expenditure, debt issuance, and other relevant activities and objectives. By integrating simulated investment outcomes with expected operational results, the CALM framework can help project key financial metrics of particular interest to the institution.

CALM is also an essential analytical tool in the case of defined benefit pension plans. The CALM approach provides a framework for reaching judgments on when and how to implement a liability-driven investment (LDI) strategy for a defined benefit pension plan and assessing the broader implications of that action. For example, the CALM framework could be used to model the reduction in expected funded status risk arising from adopting an LDI strategy. Armed with this analysis, fiduciaries would be able to judge whether the reduction of funded status risk might open up possibilities for increased risk-taking in other investment portfolios or elsewhere in the institution's operations and finances.

An OCIO that has the analytical tools to develop a comprehensive and integrated view of the institution's finances and the role of investments in that broader context can provide fiduciaries important insights into enterprise-wide risk management. As financial markets and the operating environment and objectives of institutional investors are constantly changing, these

FIGURE 2:
Fully Integrate Investment Portfolios with Core Operations and Finances



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analytical tools will need to be applied dynamically to assess how best to adapt investments to changing circumstances.

Manage the total portfolio

The traditional fiduciary model described earlier tends to be manager-centric. The bulk of an average investment committee's agenda is consumed with hiring, firing, and reviewing individual managers. Few fiduciaries have the analytical tools to assess and manage the underlying exposures resulting from isolated manager decisions and how these risk exposures relate to other exposures within the asset class concerned and across the entire portfolio.

The manager-centric approach is deficient on two counts. It focuses on a single source of potential added value, manager alpha, and cedes control of the underlying exposures within an asset class to individual manager decisions. A better approach is to structure each asset class and the total portfolio with an explicit goal for tilting underlying exposures to reflect relative valuations. This asset class structuring approach requires sophisticated analytical tools to disentangle the underlying exposures of each manager and aggregate these exposures across all managers to model the risk of each asset class and the total portfolio. With these tools, managers are not chosen in isolation based solely on an assessment of individual risk-adjusted return prospects, although that clearly remains a key factor. Under the asset class structuring approach, each manager must have favorable risk-adjusted return prospects and also comprise a bundle of risk exposures that fit well with the entire portfolio and the investment posture considered advantageous given relative valuations.

The manager-centric approach also neglects a critical element of risk management: the identification and mitigation of unintended concentrated positions within the portfolio. For example, a portfolio may have a number of U.S. equity managers that superficially appear to be diversified, but are all betting, say, on a cyclical upturn. Worse still, this same underlying bet could well be replicated more widely in non-U.S. equities. If the expected cyclical upturn fails to materialize, the hitherto hidden concentrated exposure will be made painfully manifest in the form of sharp declines across the asset classes affected.

An OCIO should have the tools needed to analyze managers' security holdings to understand their underlying risk factor exposures in the context of the total portfolio and to use this analysis to structure the portfolio to add value and control risk.

Strengthen the investment governance framework

CIO outsourcing should also contribute to improved governance through two key channels. First, as already discussed, the delegation of policy implementation, portfolio management, risk budgeting, and reporting to a single co-fiduciary frees the investment committee and other fiduciary bodies to focus on key strategic issues. As the framework of delegation is established and tested over time, senior management and the boards to which they report will be able to refine their investment, financial, and operational strategies based on a more robust analysis of investment risk and a more quantitatively integrated view of how investments fit into the broader financial picture.

A long-term strategic perspective grounded in a rigorous and realistic assessment of forward-looking return prospects and an institution's ability to bear risk can also help avoid common sources of dysfunctional investment governance. For example, an investment process based on a long-run assessment of relative valuations will reduce the temptation to follow beguiling but ultimately unsustainable trends that end in bursting bubbles.

Moreover, the availability of a disciplined framework for risk assessment, like the CALM approach described above, should help decision makers anticipate adverse outcomes and prepare possible responses to them. Taking a realistic view of the likelihood of serious downside risk and considering, in advance, the potential actions to take in the event of a tail event can prevent knee-jerk reactions that typically do more harm than good. By providing such a framework of analysis, the right co-fiduciary partner can help strengthen investment governance and ultimate outcomes.

Given the goal of strengthening the investment governance framework, it is essential that the OCIO have a strong culture of compliance and, as already indicated, be prepared to take on the responsibility of a co-fiduciary. The issue of delegation and discretion is critical. Having chosen a trusted co-fiduciary with a strong culture of compliance, the OCIO's latitude for action and initiative must be clearly defined. Good governance requires that there be an agreed framework for delegating investment decisions that unambiguously assigns responsibility for different tasks and establishes clear lines of accountability.

Ensure an alignment of interests

Some firms offering OCIO services are inherently conflicted. Their solution is limited to the use of only in-house managers or funds, precluding meaningful customization and potentially preventing access to the best managers available. In contrast, a true cofiduciary partner should provide an open architecture approach that permits customized investment solutions that are unequivocally aligned with the client's objectives.

An open architecture approach orients manager selection to the search for the best investment management talent across asset classes. This approach also eliminates conflicts of interest in manager selection. Manager searches are focused on identifying managers with the best risk-adjusted net-of-fee return potential, whose strategy, style, and underlying risk factor exposures fit well within the intended total portfolio structure. An open architecture framework can also prevent unnecessary manager turnover at the time of adopting an OCIO approach. Legacy managers with good prospects that fit within the new investment policy and targeted portfolio structure can be retained, avoiding unnecessary trading and transition costs.

The alignment of interests can be further reinforced by requiring full transparency into fees and management costs. The use of referral fees, or other potential sources of conflict of interest, generally should not be permitted.

Seek a full range of services

An OCIO should provide a full range of customized services, from investment policy design, implementation, and risk management to reporting, fiduciary education, and audit, and tax support. The key services of the total package should include:

- Investment policy design and asset allocation study
- Comprehensive discretionary active management of the assets
  - Asset allocation
  - Asset class structuring (i.e., within each asset class, where there are key decisions to be made, such as large cap vs. small cap, developed vs. emerging markets, etc.)
  - Manager sourcing, due diligence, selection, contract negotiation and execution, monitoring and transition
- Implementation of investment decisions
- Comprehensive risk management and risk-budgeting
- Selection and oversight of alternatives strategies
- Sophisticated implementation strategies such as portable alpha
- In-house asset management for efficient passive exposure
- Coordination with appropriate providers as necessary (e.g., custodian, auditor, actuary)
- Education for investment committee members
- Dedicated client service and comprehensive, yet easy-to read, reporting
- Full middle- and back-office support, including support for audit and tax

FIGURE 3:
Partner with Outsourced CIO with Depth and Experience

Partner with Outsourced CIO with Depth and Experience		
Supplement internal investment and back office resources	Enhance analytical and operational capabilities	Benefit from strategic and tactical insights to add value and manage risk

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Strengthen Governance		
Ensure that outsourcer's interests are aligned with yours	Set clear guidelines, lines of responsibility and benchmarks	Delegate portfolio management and policy implementation

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Enhance Risk-Adjusted Return Potential		
Take a comprehensive approach to risk management	Manage total portfolio, not silos of assets; seek multiple sources of alpha	Rebalance actively to maintain targeted tactical risk exposures

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Focus on Strategy to Take Control of Essentials
Use added resources and time to ensure that investments remain aligned with core mission and strategic objectives

Conclusion

Attempting to control each of the multitude of tasks—big and small—inherent in managing complex investment portfolios often results in losing control of the essential big picture. Instead of focusing on strategies for managing investments to support the mission and broader operations and finances of the sponsoring institution, limited internal resources and governance bandwidth are consumed by second order tasks. A strong partnership with a co-fiduciary can reorient the focus of investment governance on key strategic issues and strengthen the effectiveness of investment oversight. We have outlined above some of the key principles of CIO outsourcing and the features that we believe should be inherent in a co-fiduciary partnership.

The Strategic Investment Group's Approach To Outsourced CIO (OCIO)

At Strategic Investment Group, we have been developing, refining, and implementing the OCIO model described above for the past 26 years. When we founded our firm in 1987, we envisaged the need for a new and different kind of investment management firm to help institutions manage growing asset pools in a complex and often inhospitable environment. From the beginning, furthering our clients' investment objectives has been our goal, and to this end we have assembled a strong team of investment professionals and developed sophisticated analytical tools.

We felt that we had a competitive advantage in recruiting and retaining an experienced, creative, and insightful group of investment professionals, and maintaining the operational and analytical systems needed to analyze and manage complex portfolios, while the vast majority of institutions responsible for large pool of assets did not. Moreover, we could be a more cost-effective solution than the alternative of developing in-house expertise, as we would be able to spread costs over an expanded client and revenue base.

We understood from our own direct experience the complex role of a fiduciary. Based on this understanding, we created an organization capable of providing sophisticated, customized investment solutions, and the full range of services—from portfolio design and manager selection to cash flow management and audit and tax support—needed to manage investment portfolios effectively.

The OCIO model that we envisioned specialized in offering customized discretionary global investment management services, comprising all available types of assets, in an open architecture platform. We chose an open architecture structure because we believe this is the best platform to provide the broadest possible opportunity set for adding value through manager selection, to facilitate customization, and to ensure an alignment of interests with our clients. We understood that no single provider could possibly provide the best solutions across all asset classes and strategies. Attempting to do so would close off insight from others and lock us and our clients into suboptimal solutions. We were convinced that an open architecture approach would also facilitate agility and flexibility, and avoid the inertia and distraction arising from the need to build up a large staff to manage a variety of strategies across all asset classes. Our open architecture structure opens up the possibility to benefit from the insights and creativity of skilled managers across the investment universe.

We emphasized customized investment solutions because we understood that no two institutions have the same investment objectives, core mission, strategic direction, and ability to bear risk. Only by developing a keen sense of how the investment portfolio fits into the core mission can we strike the right balance of risk and return.

We also understood the need to emphasize sound investment governance. We had observed with lamentable frequency the symptoms of poor investment governance—high manager turnover, performance-chasing, rigid decision-making rules, misplaced priorities, excessive costs, inconsistent decision-making, conflicts of interest, a beauty contest approach to picking managers, and a paint-by-numbers approach to asset class structure—and realized that without sound governance, consistently strong investment performance was impossible. We therefore developed a strong culture of compliance, developed a fee structure and approach to manager selection that aligned our interests with our clients, and undertook to educate our clients on the typical pitfalls of poor investment governance. Much of our reporting, analysis, and discussions with our co-fiduciary partners are focused on making them aware of the full range of possible investment outcomes and quantifying as much as possible the impact of good and bad outcomes on the key financial metrics important to the institution.

Experience, insight, discipline, efficiency, cost-consciousness, and sound governance are key ingredients to generating superior investment returns. We at Strategic combined these key ingredients with a client-centric culture of customized service and sprinkled in a pinch of creativity to offer, over the past quarter century, what we consider to be the best and most complete package of outsourced CIO services available. We are committed to further refining this model in the years to come.

Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., hedge funds, real estate, and/or private equity) or international investments, or manage strategies with high potential for adding value (e.g., portable alpha through investor-friendly turnkey structures). Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

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