DOES OUTSOURCING MEAN I LOSE CONTROL?

Strategic Investment Group®

Fiduciary Insights

HIRING AN OUTSIDE FIRM TO ASSUME THE DAY-TO-DAY OVERSIGHT OF INVESTMENT MANAGEMENT MAY SEEM TO REQUIRE LOSING CONTROL OF THE INVESTMENT FUNCTION. On the contrary, outsourcing can increase control by enabling fiduciaries to focus on governance, investment policy, and other high-level issues. The trick is to pick an outsourcer that can adapt to the client's specific needs for control and information.

Losing Distractions, Not Control

The day-to-day management of an investment organization can be a demanding, time-consuming business, full of distractions. Among these costly, time-draining activities are:

- hiring, firing and monitoring external managers,
- writing investment guidelines,
- maintaining a specialized internal staff,
- developing or purchasing analytical and accounting systems to track investments,
- negotiating legal agreements with managers and custodians,
- struggling with compliance regulations,
- fielding marketing calls and visits,
- preparing periodic reports on investments for senior management, and
- staying abreast of ever-changing conditions in capital markets.

After attending to all these tasks, many organizations find that they do not have much real control, because there is little time left to manage the big picture. By running their own internal investment management operation, what many fiduciaries are retaining is not control over their investments, but distractions that hinder effective control.

Outsourcing solves fiduciaries' most common control problem—being pulled in too many directions. By shifting daily burdens to a manager-of-managers firm, outsourcing liberates fiduciaries to focus on the highest levels of management: governance and investment policy issues.

These important aspects of investment oversight can be readily separated from day-to-day maintenance functions. All the sponsor organization needs to keep is a cadre of senior decision-makers, usually a small investment committee that meets periodically with the manager-of-managers firm. The distractions are handled by the outsourcer, who will also assist the decision-makers in investment policy and contribute specialized expertise and client education to their deliberations, as needed.

Controlling the Delegation of Control

The very process of hiring a manager-of-managers firm resolves many control issues. Appointing the firm naturally forces an organization to spotlight the crucial aspects of fiduciary oversight in order to identify what authority it is important to keep and what authority should be delegated to the outsourcer.

Likewise, as the plan sponsor undergoes the legal process of carefully defining the scope of the relationship in an investment agreement, it voluntarily specifies the responsibility granted to the outsourcer.

The plan sponsor never gives away more authority than it wants to, nor loses the ability to revoke delegated authority previously given.

Organizations that want to retain some control of the outsourcer's investment activities can set guidelines to do so in a variety of ways. For example, maximum permitted allocations to the riskier asset classes can be specified. Lists of restricted securities can be imposed on the accounts that the outsourcer establishes. Minimum credit quality can be mandated. The plan sponsor can also require that its investment committee be included at critical decision points in changing asset allocations or hiring managers.

Care must be taken, however, not to tie the hands of the outsourcer or micromanage. Unnecessary restrictions will simply impede the outsourcer's efforts and foster suboptimal performance. As in any delegation situation, keeping control is easy; giving it away intelligently is difficult. The outsourcer will have experience and suggestions for where best to draw the line.

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Working within the plan sponsor's boundaries, a qualified outsourcer will also have an internal staff able to respond to the client's other unique needs. From the outset of the client-outsourcer relationship, issues are bound to surface in the areas of investment policy, legal responsibility and administration. In addressing these issues, the outsourcer will need to be adaptable. Since the outsourcer is assuming many burdens of the fiduciaries, the ability to accommodate their needs is crucial.

Testing for Adaptability

Testing an outsourcer's flexibility during the search phase will help allay concerns about control. The plan sponsor should ask such questions as:

- Can the outsourcer work within the plan sponsor's current investment policy?
- How regularly will the outsourcer advise and assist the investment committee?
- Can the outsourcer adopt existing manager accounts?
- Does the outsourcer insist on putting all clients into its own commingled investment vehicles?
- Which personnel will be assigned to the relationship?
- Will a change of custodians be required?

These questions pose challenges to the outsourcer's willingness and ability to modify its mode of operation to suit the client. Outsourcing firms that run a one-size-fits-all operation, cannot respond creatively, or are too big to take care of small clients, will fail this test. Organizations that hire these firms will lose some control by adapting to the outsourcer instead of having the outsourcer adapt to their needs. Customization is a form of service, and an unwillingness to customize indicates a low level of service. Moreover, an important element of a good relationship involves being able to get special treatment when needed.

The fiduciaries will want good communications with the outsourcer, enabling them to get the information they need to retain effective control.

Information Flow

Outsourcing the investment function reduces multiple client-agent relationships to just one. By hiring an outsourcer, the plan sponsor, having previously had direct contact with many service providers, sets up a more centralized and controllable information flow. The outsourcer can provide current information about managers, market developments, best investment practices, investment policies, benchmarks, and many other aspects of overseeing an investment pool. Therefore, the fiduciaries will want good communications with the outsourcer, enabling them to get the information they need to retain effective control.

The plan sponsor should view the outsourcer as a conduit for information. Further, the fiduciaries should carefully consider what information they need and ask how the outsourcer will deliver it. Just as important is information about the many relationships that the fiduciaries have entrusted to the outsourcer. Delegating oversight of these relationships does not diminish their need to know about them.

A qualified outsourcer will have established efficient means of communicating important information back to the plan sponsor. The job of communicating falls on the outsourcer's client service team, which has to know what information and which issues are important to each client. The quality of the client service operation will largely determine whether the plan sponsor feels satisfied about information flow and, by extension, feels confident about having sufficient control.

Client Education

Beyond simply delivering information about operations, the outsourcer should be able to educate the fiduciaries concerning both the many abstruse concepts and theories that exist in investment management, and the many investment tools at their disposal. The fiduciaries' decisions on many policy matters with long-term consequences will depend on their informed understanding of these ideas, and their teacher will be the outsourcer.

An important benefit of hiring an outsourcer is broadening the fiduciaries' knowledge by buying the expertise of a specialist organization that faces a wide array of investment issues for multiple clients. The outsourcer's contribution of expertise also adds to the client's control, as knowledge lays the basis for effective control.

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Conclusion

Outsourcing the oversight of investment management need not mean losing control of it. It can actually enhance control by enabling fiduciaries to focus on broad issues instead of scattering their attention over the minutia of day-to-day management. The key to retaining effective control is to pick an outsourcing firm that can adapt to the needs of the fiduciaries, and to ensure that the outsourcer supplies the right information to enable the fiduciaries to exercise the degree of control they want and need.

Strategic Investment Group

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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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