OCIO PERFORMANCE MEASUREMENT AND ANALYSIS

Overcoming the Challenges of Evaluating the Returns of OCIO Providers

Strategic Investment Group®

Fiduciary Insights

LACK OF UNIFORMITY IN PERFORMANCE REPORTING STANDARDS AMONG OUTSOURCED CIO (OCIO) PROVIDERS HAS MADE COMPARING THEIR PERFORMANCE A DIFFICULT TASK. This paper proposes tools for successfully assessing returns of OCIO providers, and also includes specific guidance on practical applications for OCIO providers to follow.

Introduction

The ultimate measure of success of an outsourced CIO (OCIO) provider is investment performance. Institutions want an OCIO firm to fulfill many different needs, but their primary aim is to find a firm that will protect and grow their assets. Thus, a clear and seemingly straightforward goal is to identify OCIO partners with a history of strong returns. However, the actual process of evaluating returns, and comparing returns among providers, can be surprisingly complex. Industry standards for reporting OCIO performance are still evolving, and what standards do exist are applied inconsistently.

Thus, although the objective is simple, the evaluation process can be complex. Understanding the challenges involved and knowing what information to request can significantly increase the chances of an informed search and ultimately increase the probability of selecting the right OCIO provider for your organization.

The OCIO Delivery System Challenge

OCIO providers employ different approaches to build and manage portfolios. Delivery systems – the way an OCIO provider constructs or delivers a portfolio to its clients – range from a single master fund to highly customized portfolios tailored for each client. While this range of choice is valuable for clients, it poses a series of challenges when evaluating performance. In a traditional investment manager search, the "deliverable" for the client is basically the same for each manager being considered. For example, in a large cap growth search, managers will have different investment strategies, but the role they play will be the same across firms. In contrast, in an OCIO search the wide range of delivery models makes it especially hard to compare returns of diverse firms.

The different models can be thought of as part of a continuum. On one end of the spectrum is a completely centralized model in which the OCIO provider manages one single master fund in which all clients invest. There is no customization, and all clients receive exactly the same return for the period during which they are invested. At the other end of the spectrum is the completely decentralized model. Here, every client portfolio is different, every client benchmark is different, and each client has a different collection of managers and mandates.

In practice, most leading OCIO providers fall somewhere on this continuum, and the optimal solution will vary based on many factors, including client size, the role of alternative investments, and the role played by legacy assets. For purposes of this paper, we will discuss three OCIO delivery systems – centralized, hybrid, and decentralized – which differ in their degree of customization.

Centralized OCIO Delivery System

At first glance, the centralized model would seem to provide the fewest challenges in reporting returns and assessing value added, but it requires informed analysis to evaluate the returns effectively. When assessing returns, here are some questions a prospective client will face:

- Are returns by asset class available?
- How are asset classes defined? For example, are long-short equity funds included in U.S. equity, global equity, or hedge funds? Is distressed debt included in fixed income, private equity, or its own asset class?
- How are returns for illiquid investments (e.g., real estate and private equity) calculated? Am I viewing a return series from investments that I could access if I were a new client?
- How are illiquid legacy holdings treated? Does the firm include in its performance composite legacy partnerships that it adopted?

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Hybrid OCIO Delivery System

Although there are many variations on the hybrid OCIO theme, the basic concept is that the OCIO provider creates asset class investment vehicles (for example, a U.S. equity commingled fund) and then allocates assets to these funds in accordance with each client's specific risk and return objectives. Clients generally can customize their allocation to each asset class, but not the managers used within each asset class. Although a hybrid model may make assessing asset class returns easier, a clear understanding of the context for those returns is important. Appropriate questions include the following:

- Are clients of different sizes treated differently? If so, what is the impact on returns?
- How does the manager define each asset class? Some firms use a single global equity "bucket" while others divide U.S. equity and non-U.S. equity. Some OCIO providers combine international and emerging market equity, and others separate them. As a result, a direct comparison of returns by asset class is not as simple as it may appear.
- Do all clients use all asset classes? Some OCIO managers offer more or less liquid variations of their portfolios. These will have different return and liquidity characteristics.
- What degree of discretion, if any, does the OCIO have with respect to asset allocation? How is that reflected in performance composites? Can a prospect assess performance at both the total fund and asset class level?

Customized OCIO Delivery System

In the customized OCIO system (which Strategic uses for most of its clients), the investment policy and the optimal delivery system for each client are customized. There is high commonality of managers within an asset class, as the OCIO provider wants all clients to benefit from its best ideas, but the manager allocations are often not identical. Portfolio size, liquidity requirements, and legacy holdings, which vary by client, account for the bulk of these differences. Although the customized model allows maximum flexibility for the client, it does complicate the task of comparing returns across providers, suggesting the prospective client should ask questions such as:

- What accounts are included in the total performance record?
- How are they weighted?
- How does the OCIO provider account for clients with different objectives? How are the aggregate benchmarks compiled?
- How are asset class returns compiled when clients use different managers within an asset class and assign differing weights to the asset classes?
- When are new clients added to (and removed from) performance composites?

Fees and Expenses

Fees and expenses present additional issues. OCIO providers have not yet developed industry-wide standards for treating their own fees or those of their underlying managers. In addition, the level of reporting made available on fees and expenses varies widely by provider. A prospective client has every right to ask for the data needed to evaluate a firm on an after-fee basis.

Recommendations for Assessing the Investment Performance of OCIO Providers

Despite these challenges, an institution conducting an OCIO search must assess the investment performance of OCIO providers. The worst outcome in the search process would be for the prospective OCIO client, feeling overwhelmed by complexity, to simply give up trying to evaluate returns. Investment performance will be a key part of the successful engagement of an OCIO provider.

Although difficult, it is possible to compare the returns of different OCIO providers. We believe the likelihood of success can be increased by following a few key disciplines in the evaluation process. We have outlined below some recommendations to consider.

1. Keep the task manageable. Conduct a comprehensive performance analysis on a limited number of managers. It is easier to do a "deep dive" on data for four to six firms than for ten to twelve firms.
2. Do not be shy about asking for data. OCIO providers should be willing to supply the information requested by a prospective client, especially if the prospect has narrowed the list of candidates down to a relatively small number. If a provider will not provide data, the refusal by itself may be a good indicator that the firm may not be an ideal partner. On the other hand, it is reasonable for an OCIO provider concerned about retaining confidentiality of returns to ask for a non-disclosure agreement.
3. Ask for verifiable returns from actual clients. It is better to use actual returns from existing clients of the OCIO provider than to use simulated or hypothetical returns.
4. Be cognizant of the limitations inherent in comparing returns of OCIO providers using different delivery systems. Perfect comparisons between providers may not be possible.
5. Know what makes up net returns. Even if the process is tedious, understand the components of the net returns the client receives, after all management and administrative expenses (which may include OCIO fees, investment manager fees, fund-of-fund fees, as well as custody, administrative, and legal expenses).
6. Use only data on accounts where the OCIO provider has full discretion. Accounts for which the OCIO provider does not have discretion do not accurately reflect the performance generated by the provider.
7. Focus on total returns versus benchmarks, and understand the benchmarks. Asset class returns can improve visibility into the investment process, which may yield valuable insights into the repeatability of returns. However, asset class returns do not show value added or detracted from portfolio-level decisions, such as tactical allocations between asset classes.

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Presenting Performance Information from the Perspective of an OCIO Provider

We believe that the OCIO industry will gravitate over time toward a set of best practices for both performance reporting and fee disclosures. In the meantime, we recognize the challenges prospects face in reviewing data from different OCIO providers. Our philosophy on this subject is to be as transparent as possible to prospects who are considering hiring Strategic, and to supply data in the format that is most meaningful. In that regard, our performance reporting policies are closely aligned with the suggestions and best practices included in the previous section.

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Listed below are some of the more important performance reporting standards that Strategic follows. We think these are reasonable and practical standards, which we expect to become part of a collection of best practices in our industry.

1. We do not report simulated returns, unless requested otherwise by a prospective client. We report only returns from actual clients where we have a verifiable investment performance history.

The challenges of assessing returns are formidable but not insurmountable, and well worth the effort.

2. All returns are reported net of fees. We believe the GIPS standard on net-of-fee reporting is applicable to OCIO providers. We do not see any reason why investment performance returns should be reported gross of fees for OCIO providers and net of fees for investment managers that are not OCIO providers. This is one area where we believe prospects can insist that any firms they are considering report net-of-fee returns.
3. We report asset class composites for all major asset classes – U.S. equity, non-U.S. equity, hedge funds, fixed income, private equity, and real estate.
4. We exclude accounts for which we do not have full discretion from our discretionary composite. We also supply information on the number of accounts and assets included in each composite.
5. We have a defined governance framework for the oversight of composites and the methodology used, with a Composite Review Committee that includes at least one member of the Legal and Compliance Department. The committee is responsible for adhering to best practices, ensuring consistency across composites, reviewing calculation methodologies, and ensuring that our internal governance standards are applied.

Conclusion

Comparing investment performance from OCIO providers can be a challenging process. A single, widely accepted set of performance reporting standards has not yet evolved within the OCIO industry. Differences in OCIO delivery systems are one key reason.

The purpose of assessing OCIO performance is to select a firm that can meet or exceed stated performance objectives. We outlined several tools and recommendations an institution can use to make the task of reviewing investment returns more manageable and productive. Finally, we listed several policies Strategic follows in reporting returns that are designed to be consistent with best practices in the industry. The challenges of assessing returns are formidable but not insurmountable, and well worth the effort.

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.

For more information, please email us at inquiries@strategicgroup.com.

Strategic Investment Group®

1001 Nineteenth Street North
16th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com