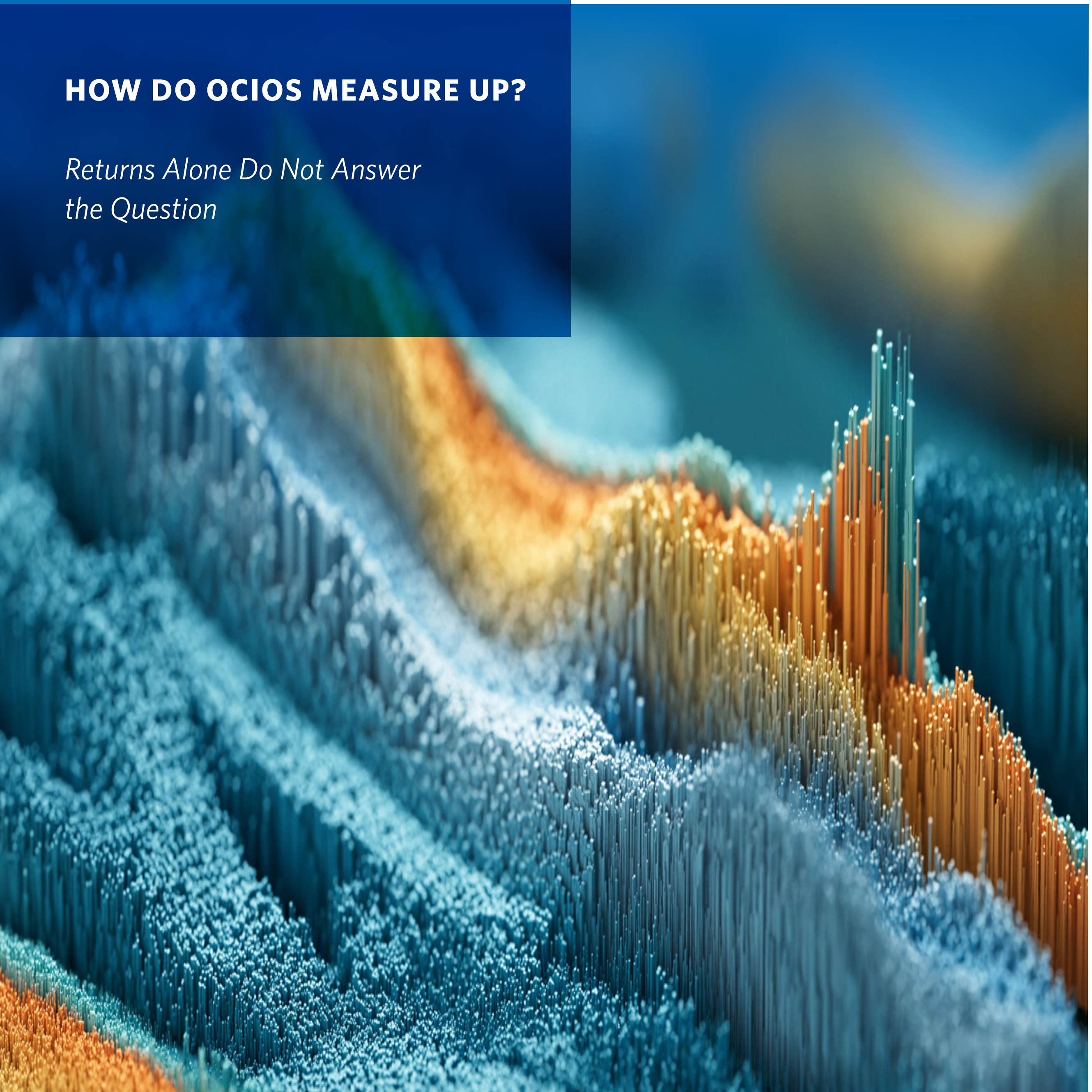
HOW DO OCIOS MEASURE UP?

Returns Alone Do Not Answer the Question



Strategic Investment Group®

Fiduciary Insights

THIS EDITION OF OUR FIDUCIARY INSIGHTS SERIES CONSIDERS HOW BEST TO COMPARE THE PERFORMANCE OF DIFFERENT OUTSOURCED CHIEF INVESTMENT OFFICERS (OCIOS). We find current approaches to OCIO assessment potentially misleading given the heterogenous nature of the portfolios managed by OCIOs. The measures currently used – raw return comparisons, and the comparison of OCIO returns using different risk buckets – are more likely to obscure than clarify the strengths and weaknesses of different OCIOs. Moreover, a comparison based on raw returns, even those using risk buckets, does not sufficiently consider the drivers of those returns, and whether past good performance represents skill or luck. We illustrate these points using quantified examples and propose an alternative that better addresses the issue of heterogeneity across OCIO portfolios.

Executive Summary

Comparing the performance of Outsourced Chief Investment Officers (OCIOs) is complicated by the heterogeneity of the portfolios they manage, a heterogeneity that reflects the varying objectives, circumstances, and attitudes toward risk of their clients. We consider the pros and cons of different approaches to OCIO performance benchmarking and suggest an alternative.

In particular, we consider the recently adopted CFA Institute's Global Investment Performance Standards (GIPS®)* guidelines for OCIOs. The new guidelines represent significant progress in establishing a basis for comparing the performance of OCIOs. However, as we demonstrate using quantified examples, serious problems remain. We argue that relying on the GIPS guidelines to assess OCIO performance can be misleading. They provide at best a first cut at assessing the strengths and weaknesses of different OCIOs.

A full appreciation of the performance of OCIO providers must focus on whether and how the OCIO has met its clients' objectives. The first question acknowledges the widely different return objectives and attitudes toward risk of institutional investors, factors that account for the heterogeneity of the asset allocations of portfolios managed by OCIOs. The second focuses on the main drivers of OCIO returns, an assessment of whether these drivers represent luck or skill, and a judgment on whether these drivers are repeatable and likely to persist. Both sets of questions – the 'whether' and the 'how' of OCIO performance – must be thoroughly explored to arrive at a full appreciation of the strengths and weaknesses of different OCIOs.

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Asset Allocation – The Prime Driver of Portfolio Performance

The returns generated by OCIOs across clients vary significantly. This divergence largely reflects differences in the strategic asset allocation of client portfolios. Every portfolio asset allocation managed by OCIOs reflects the unique circumstances, investment objectives, and risk tolerance of each client. As a result, the asset allocations of the portfolios managed by OCIOs for different clients are heterogeneous. When considering how best to measure the relative performance across OCIOs, it is essential to remember that the strategic asset allocation decision is the prime determinant of a portfolio's expected return and risk. The wide diversity of client investment objectives and strategic asset allocations creates a serious aggregation problem for designing an OCIO benchmark.

Pitfalls of Judgments Based on Returns Alone

Given the difficulty of constructing a representative benchmark for OCIO performance, it is tempting to resort to the expedient of comparing the absolute returns of OCIOs. While apparently straightforward, this approach glosses over the heterogeneity of OCIO portfolios and the reasons for the wide range in asset allocations. It also fails to assess the risks underlying the returns being compared. The elemental insight that risk and return go hand in hand is routinely ignored when comparing investment performance across OCIOs.

Current approaches to OCIO assessment are potentially misleading given the heterogeneous nature of the portfolios managed by OCIOs. The measures currently used – raw return comparisons and the comparison of OCIO returns grouped by risk buckets – are more likely to obscure than clarify the strengths and weaknesses of different OCIOs. Moreover, these approaches do not consider the drivers of those returns, including critically the level and type of risks taken.

Assessing performance across OCIOs by comparing their absolute returns ignores the elemental insight that risk and return go hand in hand. Comparing the returns of OCIOs grouped by risk buckets partially addresses the problem of heterogeneity across asset allocation and risk of OCIO portfolios. However, if the risk buckets include portfolios with widely different asset allocations and risk and return characteristics, an apples-to-apples comparison remains elusive.

The focus on absolute returns also leaves unanswered the critical question of what drove the returns and whether these return drivers represent skillful portfolio management or the luck of being heavily invested in a particular market segment when that segment was enjoying an especially strong performance. Understanding the drivers of return is an essential prerequisite for forming a judgment on whether good performance is likely to persist.

Pros and Cons of Risk Buckets

Recognizing that OCIO evaluations cannot be based on returns alone, some have proposed aggregating OCIO performance across client portfolios into risk buckets. A prime example of this approach is the CFA Institute's new GIPS guidelines for OCIO portfolios (the "Guidelines"). The Guidelines partially tailor GIPS to the particular features of OCIO portfolios and represent an improvement over the previous standards. The improvements include a requirement that performance reported by OCIOs be based on actual returns on discretionary portfolios, rather than hypothetically modeled portfolios, and better disclosures on fees and the asset allocation of OCIO portfolios. Despite these improvements, the Guidelines have three significant remaining shortcomings that impede an apples-to-apples comparison of performance across OCIOs.

- ***Wide risk bucket ranges.*** The risk bucket ranges used by the Guidelines to categorize different portfolios are very broad. The expected risk and return of portfolios at the top of the range will differ significantly from those at the bottom, making an apples-to-apples comparison difficult.
- ***Broad definition of asset groupings.*** The Guidelines group assets into two broad categories: liability-hedging/risk-mitigating and growth. The former includes investment grade bonds and some hedge funds, while the latter encompasses everything else. As a result, portfolios with widely varying allocations to private and public equities will be grouped together, compounding the difficulty of making clear cut comparisons.
- ***Different objectives of pensions and endowments.*** Finally, the Guidelines do not take adequate account of the different objective functions of pensions and endowments. A pension's objective function often favors minimizing funded status volatility over absolute return. Absolute return is therefore an unsuitable metric for judging the relative performance of OCIOs managing pension portfolios.

Wide Range of Risk Bucket Composites

Consider first the broad risk bucket bands of the composite portfolios set out in the Guidelines. The bands range 15 percentage points in the case of more aggressive portfolios, 20 percentage points in the case of moderately risky portfolios and 25 percentage points in the case of more conservative portfolios (Exhibit 1). As we illustrate with quantified examples in the next section, these wide bands can result in significant variability of returns between portfolios at the top and bottom of the composite bands.[1]

Broad Definition of Asset Class Groupings

A further source of return dispersion within each composite arises from the very broad definition of the asset classes included in the liability-hedging/risk-mitigating and growth composites specified by the Guidelines (Exhibit 2). Growth assets, for example, encompass all assets other than investment grade bonds and some hedge funds. The growth composite thus runs the gamut from high-yield bonds to commodities, venture capital, and everything in between. The liability-hedging/risk-mitigating portfolios can also comprise a diverse range of assets with divergent risk and return characteristics. Long-duration bonds, for example, are treated as having similar risk and return characteristics as the risk-free rate. Differences in the asset composition of the composites specified by the Guidelines is thus a further source of return variability of portfolios grouped in the same composite.

[1] At the other end of the spectrum, creating very narrow risk buckets can also be problematic as it would overly restrict the number of OCIO portfolios included in each bucket.

EXHIBIT 1: GIPS GUIDELINES FOR CONSTRUCTING RISK BUCKETS

Source: CFA Institute. Global Investment Performance Standards Guidance Statement for OCIO Portfolios.

Required OCIO Composites	Strategic Allocation to:	
Liability-Focused Strategy	***Liability-Hedging Assets***	***Growth Assets***
Liability-Focused Aggressive	0%-14%	86%-100%
Liability-Focused Moderate Aggressive	15%-29%	71%-85%
Liability-Focused Moderate	30%-49%	51%-70%
Liability-Focused Moderate Conservative	50%-74%	26%-50%
Liability-Focused Conservative	75%-100%	0%-25%
Total Return Strategy	**Growth Assets**	**Risk-Mitigating Assets**
Total Return Aggressive	86%-100%	0%-14%
Total Return Moderate Aggressive	71%-85%	15%-29%
Total Return Moderate	51%-70%	30%-49%
Total Return Moderate Conservative	26%-50%	50%-74%
Total Return Conservative	0%-25%	75%-100%

Different Objective Functions of Endowments and Pensions

Finally, the objective function of endowments and pensions differ fundamentally. A typical endowment views portfolio construction from the prism of absolute return and risk while a pension portfolio following a liability-driven investment (LDI) approach focuses on return relative to liabilities and sees risk in terms of funded status volatility. Endowments often target a return sufficient to fund a spending objective while preserving the real purchasing power of the endowment. A pension aims at meeting its benefit obligations at the least cost while achieving and maintaining a fully funded position in which the present value of the pension's assets and liabilities are kept broadly in line.

Given these different objective functions, measuring the success or failure of a pension portfolio requires a different metric than an endowment portfolio. It is misleading to judge the relative performance of pension portfolios pursuing an LDI strategy by their absolute return. An assessment of an OCIO managing pension portfolios should instead focus on an analysis of the drivers of changes in the pension's funded status and how the OCIO's management of the portfolio contributed to improving the pension's funded status while limiting funded status volatility. A pension with a lower absolute return may well be better fulfilling its mandate than a pension with a higher absolute return.

SIDEBAR GLOSSARY

Growth vs. Liability-Hedging Assets

Growth Assets: Aim for higher returns but carry more risk (*e.g.*, public and private equity).

Liability-Hedging Assets: Focus on stability and matching future obligations (*e.g.*, cash and investment grade bonds).

EXHIBIT 2: GIPS GUIDELINES FOR CREATING ASSET GROUPINGS

Source: CFA Institute. Global Investment Performance Standards Guidance Statement for OCIO Portfolios.

Asset Class/Type	Liability-Focused Composites	Total Return Composites
Investment-grade fixed income	Liability-hedging	Risk-mitigating
Cash	Liability-hedging	Risk-mitigating
Hedge funds	Liability-hedging or growth	Risk-mitigating or growth
All other assets	Growth	Growth

Our quantitative analysis of the composites proposed by the Guidelines highlights the variability of returns arising from their wide risk bucket bands, the broad composition of risk-mitigating/liability-hedging and growth composites, and the interaction of these two effects.

Quantitative Analysis of Guideline Composites

We have undertaken a quantitative analysis of the composites proposed by the Guidelines to highlight the variability of returns arising from their wide risk bucket bands, the broad composition of risk-mitigating/liability-hedging and growth composites, and the interaction of these two effects.

We have constructed illustrative portfolios that meet the criteria of the composites and calculated their expected return and risk using the publicly available capital market assumptions published by J.P. Morgan.[2] These capital market assumptions include projections of the long-term return, volatility, and correlation of the major asset classes.[3] Using these data, we have constructed an efficient frontier highlighting the return and risk characteristics of portfolios whose asset allocations represent an optimal combination of assets (Exhibit 3). As is evident in Exhibit 3, the assets characterized as growth by the Guidelines have widely divergent risk and return characteristics, ranging from high yield bonds at one end of the risk/return spectrum to private equity at the other.

We have constructed five illustrative portfolios for each composite risk bucket set out in Exhibit 1. To illustrate the potential impact of wide bands on return, the allocation of each of the five portfolios to growth assets runs from the bottom to the top of the range specified for each risk bucket by the Guidelines. The portfolios also test the impact of different allocations to the wide range of assets considered to be "growth" in the Guidelines. Using the moderately aggressive composite of the Guidelines as an example, we illustrate the asset class composition and expected return of the five illustrative portfolios constructed for that composite risk bucket (Exhibit 4).

The expected returns of the portfolios highlighted in Exhibit 4 range from a high of 9.1% to a low of 7.6%, a spread of 150 basis points. There are two main sources of this dispersion – the wide range of the bands of the moderately aggressive composite risk bucket and the scope for structuring the growth segment of each portfolio using a wide range of assets with very different risk and return characteristics. This 150 basis point spread is wide enough to be the difference between mediocre and stellar performance.

The asset class composition of the portfolios highlighted in Exhibit 4 are typical of many endowment portfolios. We have expressly avoided using extreme outliers to highlight the deficiencies of the composite risk buckets set out in the Guidelines. It is possible, however, to construct portfolios with much wider return variations.

[2] See J.P. Morgan's 2025 Long-Term Capital Market Assumptions (29th edition). The J.P. Morgan data have the benefit of being comprehensive, of long pedigree, and publicly available. However, we would have obtained similar results using the long-term capital market assumptions of many other providers.

[3] All return data are arithmetic nominal returns.

EXHIBIT 3: EFFICIENT FRONTIER

Sources: J.P. Morgan and Strategic estimates and calculations. Data are nominal average returns. J.P. Morgan's capital market assumptions treat hedge funds as growth assets. Growth assets are represented by the blue diamonds. Risk-mitigating/liability hedging assets are in orange.

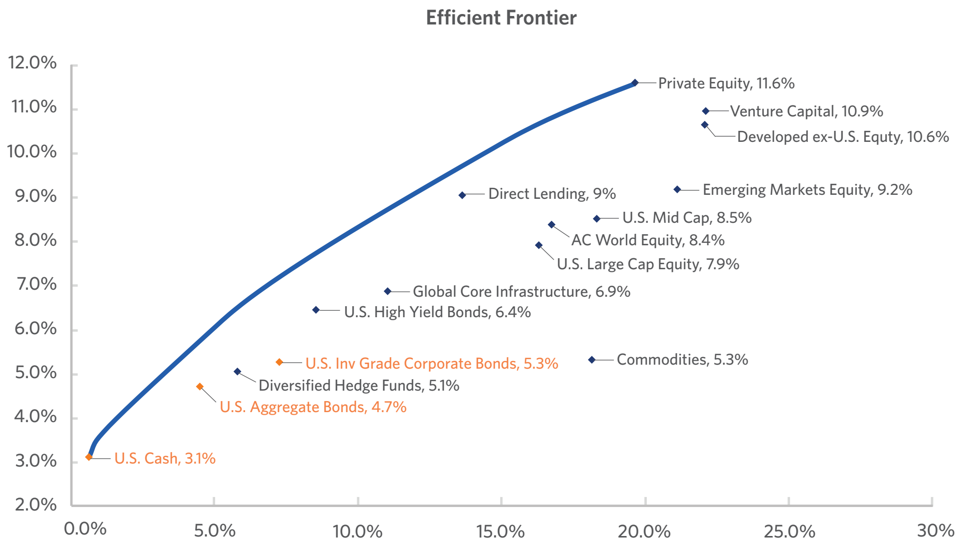
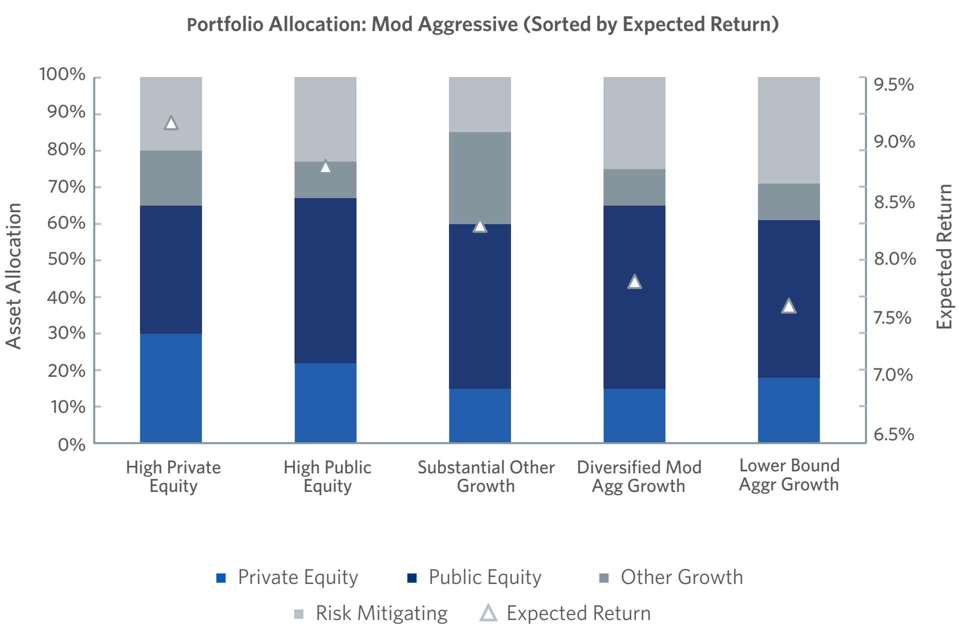


EXHIBIT 4: ILLUSTRATIVE PORTFOLIOS OF THE MODERATELY AGGRESSIVE COMPOSITE RISK BUCKET

Sources: J.P. Morgan, CFA Institute, and Strategic estimates and calculations. Bars show the asset allocation of each portfolio (left-hand side). Diamonds represent the return of each portfolio (right-hand side).



Our quantitative analysis underscores the point that decisions based on returns calculated using the methodology of the Guidelines could lead the unwary to choose one OCIO over another not because of their relative skill, but merely because of how their portfolios were allocated.

The following matrix highlights the potential range of return outcomes as a function of the asset allocation bands of the moderately aggressive portfolio composite risk bucket and the scope for structuring the growth segment of the portfolio using a wide range of assets (Exhibit 5). We focus on the impact of different shares of private equity in the growth segment of the portfolio ranging from a low of 20% to a high of 80%. For simplicity, we assume that the balance of the growth segment is allocated to U.S. large-cap equities. We further assume that the risk-mitigating/liability-hedging segment of the portfolio is allocated to the U.S. aggregate bond index.

As highlighted by the return matrix of Exhibit 5, the total return of the moderately conservative composite risk bucket specified by the Guidelines could range from a low of 7.50% to a high of 10.57%, a spread of just over 300 basis points.[4]

These quantified examples underscore the point that decisions based on returns calculated using the methodology of the Guidelines could lead the unwary to choose one OCIO over another not because of their relative skill, but merely because of how their portfolios were allocated. Recall, however, that the asset allocation decision is made by each client based on its return objectives and risk preferences. Returns generated while meeting client preferences do not make for a sound basis to judge performance across OCIOs.

While the above analysis focuses on the moderately aggressive portfolio specified by the Guidelines, the point holds across all of the various composite risk buckets used in the Guidelines. As highlighted in the scatter diagram on page 7, all of the composite risk buckets of the Guidelines generate a wide range of returns depending on where the portfolios lie on the asset allocation bands and how the growth segment is structured (Exhibit 6).

EXHIBIT 5: EXPECTED RETURN RANGE OF MODERATE AGGRESSIVE PORTFOLIO

Sources: J.P. Morgan, CFA Institute, and Strategic estimates and calculations. Numbers within the matrix are the expected nominal return for each illustrative moderately aggressive portfolio. The illustrative portfolios are constructed using the allocations to private equity highlighted in the horizontal axis and the share of growth shown in the vertical axis.

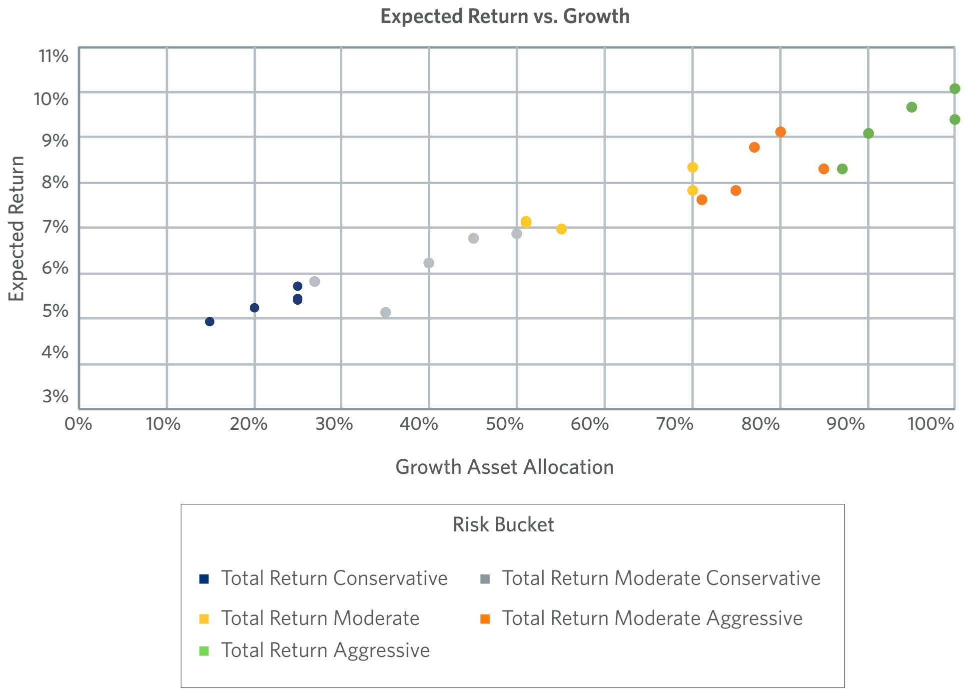
Share of Private Equity in Growth

Share of Growth in Composite	20%	40%	60%	80%	100%
71%	7.50	8.02	8.55	9.07	9.60
73%	7.58	8.12	8.66	9.20	9.74
75%	7.66	8.21	8.77	9.32	9.88
77%	7.73	8.30	8.87	9.44	10.01
79%	7.81	8.40	8.98	9.57	10.15
81%	7.89	8.49	9.09	9.69	10.29
83%	7.97	8.58	9.20	9.81	10.43
85%	8.05	8.68	9.31	9.94	10.57

[4] Even this 300 basis point spread is not the maximum spread that could be achieved while remaining in line with the Guidelines. Had we used high yield bonds instead of publicly traded equities as the complement to private equity in the growth bucket, the range would have been 400 basis points.

EXHIBIT 6: RETURN DISPERSION OF PORTFOLIOS IN GIPS COMPOSITES

Sources: J.P. Morgan, CFA Institute, and Strategic estimates and calculations.



Composites Provide Useful Context, Not the Full Story

Even if it were possible to design a benchmark for OCIOs that fully overcame the problem of aggregating heterogenous portfolios, further analysis of the sources of their return would remain essential. Understanding how a manager generates returns helps address several key questions. *Are the returns the result of luck or skill? Are they the artifact of a particular historical period? Are the manager's returns likely to persist? Does the manager have the process, systems, and analytical framework to repeat success?*

Answering these questions requires a rigorous attribution analysis that quantifies the types of active positions and strategies that contribute to the OCIO's returns and how its positioning responds to changing market environments. For example, an OCIO whose returns largely reflect a sector bias that was advantageous in a particular market cycle, might not perform as well when the cycle turns. Similarly, performance reliant on a few large positions is unlikely to persist and may prove highly volatile. In contrast, a strategy that focuses on combining a large number of complementary active decisions is a much more reliable source of sustained performance.

A focus on performance relative to a benchmark that does not disentangle the sources of return provides no basis for forming a judgment on the repeatability and persistence of performance. This is especially true when the benchmark in question suffers from the aggregation problems we have just highlighted.

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An Approach to OCIO Evaluation That Measures Up

To overcome the problem of aggregating heterogenous portfolios, we suggest that OCIO returns be assessed from the bottom up. A bottom-up approach will shed light on the quality and likely persistence of the OCIO's performance.

Given the difficulties just described, how does one go about choosing an OCIO? In this section, we suggest an approach to evaluating an OCIO's returns that avoids some of the pitfalls we have just identified and quantified.

Assessing OCIO Performance – Measure from the Bottom Up

To overcome the problem of aggregating heterogenous portfolios, we suggest that OCIO returns be assessed from the bottom up. A bottom-up approach will shed light on the quality and likely persistence of the OCIO's performance.

- ***Consistency of returns across asset classes.*** As a first cut, analyzing the returns generated by an OCIO in each asset class will provide clues on where an OCIO's strengths lie. The asset class returns used should be representative of all of the portfolios managed by the OCIO. Ideally, the OCIO's performance will evidence an ability to add value consistently across all asset classes. An OCIO overly reliant on strong performance in only one or a few asset classes, or whose performance is concentrated on a short period or particular point in a market cycle should raise concerns. When analyzing the returns across asset classes, it is important to understand the types of investment in each asset class. *Does the OCIO follow standard industry definitions and use standard benchmarks, or are its asset classes hodgepodge grab bags of all and sundry? Are the OCIO's asset class returns presented following GIPS standards?*
- ***Source of asset class returns.*** After the first cut of ascertaining whether the OCIO's performance is consistent across asset classes, time horizons, and market cycles, it is important to analyze the sources of asset class returns. A value-added attribution analysis of these returns should be undertaken to address the following question: *Do these reflect a large number of independent sources of value added generated by the security selection of skilled active managers, or are the returns the result of a small number of concentrated style or sector bets?* This analysis will provide a basis for assessing the likely persistence of the OCIO's performance.
- ***Drivers and magnitude of active tactical positioning across and within asset classes.*** It is also critical to understand the basis for the OCIO's decisions to make active asset allocation shifts across assets and segments within assets. *Are these active top-down positions based on an assessment of the deviation of price from fundamental value? Does the sizing of these positions consider the level of risk of each position? What is the relative share of the risk budget devoted to top-down versus bottom-up active positions?*
- ***Alignment of philosophy.*** *What is the investment philosophy underlying the OCIO's decisions on active positioning? Is this investment philosophy sound, internally consistent, and actually reflected in the OCIO's actions? Has this philosophy been followed consistently over time? Is the OCIO's investment philosophy aligned with your own beliefs?*

Building a Better Benchmark

The bottom-up approach to OCIO evaluation advocated above, while in our view optimal, requires considerable analysis. There are times, particularly at the onset of a search, when a rough and ready evaluation is needed to make the first cut of the OCIOs under consideration.

In such cases, we recommend building a total portfolio return profile of each OCIO under consideration using their reported returns for each asset class and weighing these returns to your preferred asset allocation. The resultant hypothetical total portfolio returns for each OCIO can then be compared with a passively constructed total portfolio return benchmark that applies the same preferred weights to industry standard benchmarks for each asset class.

This asset class approach solves many of the problems associated with judgments based on absolute returns alone or on risk bucketing. In particular, this approach avoids the problem of widely divergent asset allocations underlying the total portfolio returns of different OCIOs. It explicitly measures value added relative to more or less consistent beta exposures across OCIOs.

However, care will still need to be taken so that the definition of each asset class is constant across OCIOs. Moreover, this asset class approach will, of course, not capture the impact of active asset allocation decisions across assets taken by the OCIO. Nor will it consider the impact of different approaches to portfolio rebalancing. Despite these handicaps, the asset class approach addresses the worst effects of the aggregation problem and facilitates a preliminary rough comparison of total portfolio performance across OCIOs. It is no substitute, however, for a detailed analysis of the underlying sources of OCIO return. Such an analysis remains the sine qua non of OCIO evaluation.

Conclusion

A key principle of accountability is that agents are responsible for actions that are within their discretion. Judgments about their performance should not be muddied by the impact of decisions taken by others.

This is the key failure of using absolute returns to compare performance across OCIOs. The heterogeneous circumstances and objectives of each client results in widely different asset allocations. As a consequence, comparing OCIOs on the basis of absolute returns is not consistent with the fundamental principle of accountability.

Even more problematic, a focus on absolute returns omits any consideration of risk. Such an approach fails to consider whether these returns were commensurate with the risk taken to generate them, and whether the risks taken would be acceptable to the client searching for an OCIO.

Risk bucketing, while having the benefit of taking some consideration of risk into account, remains a blunt tool that papers over significant differences in underlying portfolio exposures and risks. Decisions based on risk bucketing are destined to miss important nuances of performance and still involve the comparison of apples and oranges.

To build a better benchmark, we suggest the asset class approach described above as a rough and ready way to make a first cut in the evaluation of OCIOs. While far from providing a comprehensive picture of performance, the asset class approach resolves some of the most egregious shortcomings of using absolute returns or risk bucketing.

Of course, there are many other factors to evaluate that we do not consider here. These include the integrity of the governance and culture of the OCIO; the OCIO's alignment with its clients as reflected in its ownership structure, incentives, and fees; the stability, breadth, and depth of its people; the quality of its internal controls and compliance safeguards; the extent of its trading capability; the rigor of its analysis and discipline of its investment process; and the comprehensiveness and clarity of its performance reports and client communications.

Ultimately, the solution to the aggregation problem that institutions face when comparing the performance of OCIOs requires a thorough analysis of the sources of OCIO returns based on a detailed value-added attribution. This analysis is needed to answer key questions at the heart of the OCIO selection. ***Does the OCIO's performance reflect luck or skill? Do the OCIO's returns result from a repeatable process or are they merely an artifact of a particular historical period? Were the OCIO's returns generated by a few concentrated active positions or did they result from many diversified sources of value added?*** And, critically, whether the risks taken by the OCIO in each client portfolio were well-rewarded and consistent with the preferences of each individual client.

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