Strategic Investment Group®

Fiduciary Insights

SLEIGHT OF HAND TRICKS:

A Cautionary Tale of OCIO Searches Gone Wrong

THE ALIGNMENT OF MANY OCIOS WITH THEIR PROSPECTIVE CLIENTS IS COMPROMISED BY INHERENT CONFLICTS OF INTEREST. Worse still, some OCIOs engage in troubling sleights of hand to win business. This edition of our Fiduciary Insights series reveals the conflicts and tricks that we regularly observe, and points out key areas to probe when considering engaging an OCIO as a co-fiduciary partner.

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To learn more about us and download our **Fiduciary Insights** series, which is dedicated to issues relevant to fiduciary best practices and responsibilities, please go to strategicgroup.com/our-thinking/research and publications. Topics include, "***Nature and Drivers of Volatility***", "***What is the Role of the IC When Hiring an OCIO***", "***The Art and Science of Manager Termination***", "***Developing a Culture of Good Governance: A Committee Self-Evaluation***", "**Common Symptoms of Poor Governance**", and "***Does Outsourcing Mean I Lose Control?***".

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Introduction

The chief responsibility of an OCIO is to act as a trusted advisor and a co-fiduciary. Alignment, trust, transparency, and a spirit of partnership are critical ingredients of a successful OCIO relationship. It is therefore essential that institutional investors carefully consider the degree of alignment and potential conflicts of interest of candidate OCIOs.

Regrettably, the alignment of many OCIOs with their prospective clients is compromised by inherent conflicts of interest. Worse still, some OCIOs engage in troubling sleights of hand to win business. This edition of our Fiduciary Insights series reveals the conflicts and tricks that we regularly observe.

Lack of alignment can lead to misleading representations of two key factors scrutinized by investors when selecting an OCIO: performance and fees. We see the most sleight of hand tricks in these two areas, making it difficult to compare different OCIOs fairly using objective criteria. We believe that when these tricks are spotted, they should be seen as red flags. Conflicts of interest and sleight of hand tricks are incompatible with the alignment, trust, and spirit of partnership essential to the co-fiduciary role an OCIO should play.

Fee Fiddles

Fee-related sleight of hand tricks fall into two main areas: the fees charged by the OCIO provider, and the estimates of fees charged by the underlying managers to be included in the portfolio. In both these areas, unscrupulous OCIO providers obscure the full costs that you will ultimately incur. These hidden costs include direct costs in the form of higher than expected fees and opportunity costs in the form of subpar performance.

Hidden Fees and Costs - Symptoms of Conflicts of Interest

Some OCIO providers do not fully disclose all of their sources of remuneration. OCIO providers with unrevealed sources of revenue are able to quote what appear to be very low direct fees. These unrevealed revenue sources take a variety of forms, all of which entail conflicts of interest. In our view, this practice should automatically disqualify the candidate OCIO for the simple reason that conflicts of interest are incompatible with serving as a co-fiduciary partner, the essential function of an OCIO.

- ***The Pay to Play.*** Some OCIO firms receive payments from the underlying managers with whom they invest client assets. Such payments include fees for database inclusion, charges to participate in client conferences, and explicit deals to split manager fees. These arrangements pose a clear conflict of interest, undermining objective manager selection with the business reality of having one eye on the additional revenue that a manager will bring. These arrangements make it impossible to have a clear picture of the sources of revenue and motivations of each agent, and ultimately result in subpar performance. These direct and opportunity costs can far exceed any illusory cost savings. Institutional investors should instead seek an OCIO whose interests are aligned with their own and who will select managers solely based on the risk-adjusted returns they expect the manager to

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generate. OCIOs whose interests are aligned with their clients will negotiate hard to achieve the best possible fees and other terms from underlying managers and pass those savings and the benefits of advantageous terms on to their clients.

- ***The Loss Leader.*** In a variant of this pay-to-play approach, some firms in effect hire themselves to manage client assets in proprietary products. From this perspective, the OCIO business is a sideline that provides a way to funnel assets to proprietary products. When this is the case, the firm generates the bulk of its earnings from its proprietary products, which subsidize low fees on its OCIO business. Such firms have the incentive to maximize the use of proprietary products across all asset classes, even when there are better options available. The cost to the client is twofold. First, the proprietary products are typically costly and may have liquidity and other terms that are disadvantageous. Second, the opportunity cost of proprietary products in the form of foregone investment performance can be high. This opportunity cost, compounded over time, will almost certainly dwarf the apparent fee savings. Consider in particular the dilemma posed when a proprietary product is underperforming. Just like the OCIOs receiving revenues from external managers, these conflicted OCIOs will be reluctant to liquidate an underperforming internal product for fear of reducing total firm revenue. In contrast, an OCIO implementing an open-architecture approach will not hesitate to take appropriate measures when a manager is not performing as expected.
- ***The Net Trick.*** A related ploy takes advantage of the difficulty of measuring the true costs of the proprietary products. This problem can be particularly acute for fund vehicles that carry two layers of fees—one for the OCIO and one for the underlying (and sometimes proprietary) managers. Because both layers of fees are often deducted directly from the fund's net asset value, unraveling the total embedded fees can be extremely difficult for a client. We regularly see OCIOs count these vehicles as having zero fees because the fees have been buried in their return streams.
- ***The Cross-Sell, and the Up-Sell.*** Some firms do not see investment management as their sole business, or even their prime focus. For these firms, providing OCIO services represents a sideline recently added to their main business. Actuarial and consulting firms (many large OCIOs are both actuaries and consultants) fall into this category. Actuarial firms engage in a cross-sell of OCIO services, while, for consultants, OCIO services are an up-sell that in some cases is virtually indistinguishable from their standard consultancy practice. For both traditional investment managers and OCIOs, we strongly believe that a singular focus produces superior performance. The client is likely to incur a large opportunity cost in the form of foregone investment performance from a firm that does not see OCIO as a competitive advantage, area of particular expertise, and main business line. Recent academic research confirms our experience that on average there is no evidence of skill among the firms that have extended their brands into the OCIO realm, despite their claims of stellar performance.[1]
- ***The Broker in OCIO Clothing.*** Some OCIOs own a brokerage business and channel their clients' trades to it. This is yet another manifestation of a conflict of interest and poses similar problems to those arising from proprietary products. In this case, the OCIO provider is able to supplement artificially low OCIO fees with the commissions of the brokerage business it owns. The client is likely to suffer from higher brokerage fees and subpar trade execution and will have once again entrusted its assets to a conflicted OCIO in the pursuit of fee savings.
- ***The Package Deal.*** Some OCIOs do not provide separate quotations of their fees from those of underlying managers, offering only a bundled fee. Because the OCIO keeps all fees not paid to underlying managers, the OCIO is incented to include a large proportion of passive strategies, index vehicles, second-tier managers with low fees, and low cost asset classes. This mix is unlikely to generate exceptionally strong returns, and the client is left once again to bear the opportunity cost of subpar investment performance compounded over time. In such cases the apparently low bundled fees present a false economy.

[1] Cookson, Gordon and Jenkinson, Tim and Jones, Howard and Martinez, Jose Vicente, Investment Consultants' Claims About Their Own Performance: What Lies Beneath? (July 19, 2018). Available at SSRN: https://ssrn.com/abstract=3214693 or http://dx.doi.org/10.2139/ssrn.3214693.

- ***The Bait and Switch.*** A final sleight of hand trick that we have observed involves quoting underlying manager fee estimates based on low-cost vehicles, including, as in the previous case of bundled fees, passive strategies and indexed funds. In this trick, the actual investment portfolio ultimately used comprises more expensive active managers and strategies. In this way, the OCIO is able to win business, albeit on false pretenses, while avoiding at least some of the underperformance that would have resulted from retaining the original line up. The client ends up selecting the OCIO for the wrong reasons and will incur higher direct costs, but at least has a better chance of avoiding some of the opportunity cost of subpar performance likely from the original manager line up.

Performance Puffery

Achieving sustained risk-adjusted value added net of all fees is the ultimate objective of all investors. Sustained strong investment performance achieved at an appropriate level of risk builds wealth over time. Performance is rightly a prime focus of institutions assessing candidate OCIO providers. However, this is another area where sleight of hand tricks regrettably proliferate.

We believe that OCIO providers should adhere to the highest industry standard when presenting performance history. The record of performance claimed by the OCIO should be based on representative composites constructed using objective criteria comprising the actual experience of a broad set of its clients. We believe that the CFA Institute's Global Investment Performance Standards (GIPS) provide a widely accepted industry standard with which all OCIO providers should comply.

Sadly, however, few OCIO providers have taken the necessary steps to be GIPS compliant. Worse still, many engage in sleight of hand tricks to puff up performance. We consider below a few of the tricks that we most frequently observe.

- ***The Hypothetical Allocation History.*** Many OCIO firms manage asset class pools that they use as building blocks to offer customized asset allocations to their clients. In some cases, the firm claims GIPS compliance by creating composites at the asset class level. Some unscrupulous OCIO providers assume allocations to the best performing pools of each period, and present performance of a total portfolio whose asset allocation changes frequently to favor the best performing asset class in each period. They then claim that this hypothetical portfolio is representative of their results, even if no client actually held the portfolio. This approach allows the OCIO provider to claim GIPS compliance while significantly inflating its claimed performance, in some cases by 150-200 basis points over a five-year period. This is an unfortunate perversion of the spirit of GIPS compliance and points to the need to probe deeply into the construction of the performance record in all cases. There should be no prizes for ex-post prescience.
- ***The Backtest Boost.*** A related gambit is the use of a backtested model to generate a history of holdings across asset classes and sometimes even manager allocations. In our three decades of experience, we have yet to see a backtested model that did not outperform, but we frequently see models that underperform in live implementation. In a particularly aggressive flourish, we have even seen backtested allocations to manager products that were themselves only backtests—a double dip of hindsight.

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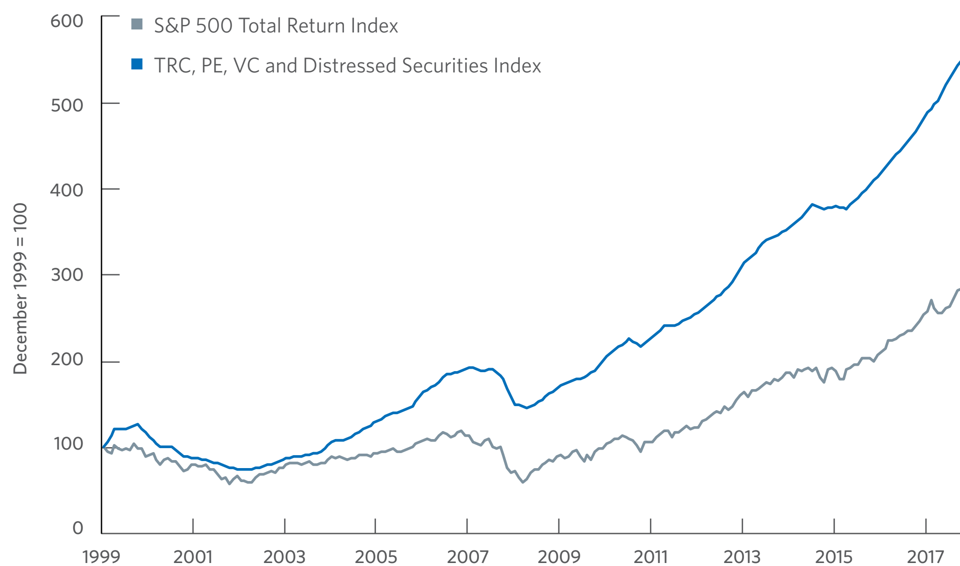
- ***The Liquidity Premium Ploy.*** Some OCIO providers compare their private equity returns to a publicly traded equity benchmark, such as the S&P 500. This approach compares the returns of an illiquid asset that should command a significant liquidity premium against a benchmark for a very liquid, publicly traded asset that commands no such premium. Considering that the typical liquidity premium sought in private equity is several hundred basis points, this practice sets a very low bar against which to judge private equity performance. Simply adding another source of risk to the portfolio should not count as added value. As illustrated in Exhibit 1, an industry standard private equity benchmark has handily outperformed the S&P 500, generating a large cumulative impact over time.

- ***The Risk Ruse.*** A similar problem that we often see is the use of total return histories with no consideration of the risks undertaken to generate the returns. As benchmarking can pose inherent complexities for portfolios that diversify globally and include alternative asset classes, some OCIOs advocate the shortcut of simply comparing total return histories, with no reference to the portfolio's allocation and volatility. The problem with this approach is that in most environments higher returns are generally associated with higher risk. A related issue arises from the way private equity performance is measured. Because private investments are marked to market infrequently and using a smoothed appraisal process, reported volatility numbers can mask the true economic risk embedded in a performance record. Just as introducing illiquid assets to the portfolio should not count as added value, simply holding a portfolio that on average is more aggressive is not evidence of skill. Again, the best measure of skill takes into account the actual level of risk of and outperformance of a portfolio versus a properly specified benchmark, net of all fees.

EXHIBIT 1:

Cumulative Impact of the Liquidity Premium Ploy

Sources: Thomson Reuters Cambridge, Bloomberg and Strategic estimates.

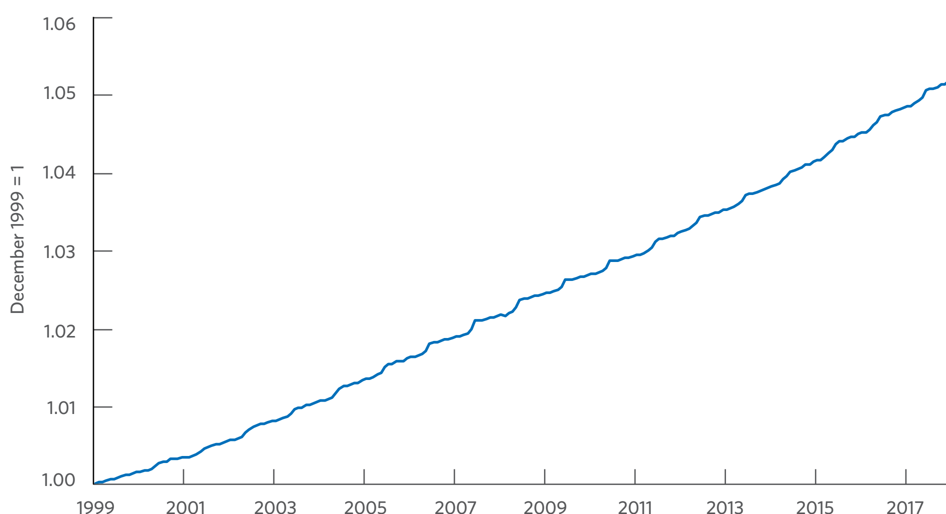


- ***The Cherry Pick.*** Many diversified asset management firms have hundreds of balanced accounts over which they have some level of discretion that could plausibly be relabeled as OCIO mandates. Many consultants are in a similar position, particularly those with a decentralized structure with no "house view." With potentially hundreds of portfolios to cite as an OCIO track record, and excluding the accounts that have been closed due to weak performance, normal statistical dispersion implies that some of the surviving accounts will have surely performed well. Cherry picking the best performers is a common practice. In one particularly egregious example, we have even seen two OCIO firms that had operated in a shared discretion structure cite the same portfolio as their own performance history.
- ***The Benchmark Alchemy.*** There are widely recognized benchmarks for each asset class that are considered industry standards because of their representativeness, investability, and transparency. Benchmark construction is complex, however, and some OCIO providers gravitate to low bar benchmarks in an attempt to burnish their performance record. To take one example, the MSCI World Index is a widely recognized industry benchmark for global equities and has many of the hallmarks of a fair and representative index. Because most investors are subject to withholding taxes on foreign dividends, MSCI publishes a version of the index that subtracts this tax drag from dividend payments globally—the MSCI World Net Total Return Index. U.S. institutional investors, however, are not typically subject to dividend withholding taxes on their U.S. investments, which constitute about 60% of the MSCI World Index. We have observed some OCIOs exploit the lower returns of "net" benchmarks like this, even though their clients are not paying all of the taxes assumed by the benchmark. The impact is significant. Using this benchmark for the total equity portfolio of U.S. clients creates ersatz value added of approximately 40 basis points per year with essentially no volatility, puffing up the unscrupulous OCIO provider's performance record with compounding over time (Exhibit 2). If an OCIO can outperform the benchmark by this much by simply investing in a passive index fund, the deck has been stacked against the client.

EXHIBIT 2:

Cumulative Impact of Benchmark Alchemy

Sources: MSCI and Strategic estimates. Compares the return of MSCI World Index with an index that does not deduct dividend withholding tax from the U.S. component of the index.



A Cautionary Tale with a Happy Ending

We hope that this account of the main sleight of hand tricks that we have observed has armed you with areas to probe when considering an OCIO but not discouraged you from undertaking the search. There are a few OCIOs that:

- Are dedicated to serving as a co-fiduciary partner and trusted advisor to their clients.
- Understand the important responsibility and position of trust that a co-fiduciary role entails.
- Focus solely on providing OCIO services without the distractions and inherent conflicts of other business lines.
- Have adopted a business model, governance structure, and compliance procedures that are free of conflicts of interest.
- Have a verifiable and long record of sustained value added as measured against appropriate benchmarks.
- Follow both the spirit and letter of GIPS.

Please do contact us if you have any questions regarding the OCIO search process. We would be delighted to share our thoughts whether or not you ultimately decide that we are the best OCIO for your institution's needs.

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 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 missions, 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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