

# EFFECTIVE OCIO OVERSIGHT

**What Does the  
Endowment Model Look  
Like For My Institution?**

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## **EXECUTIVE SUMMARY**

An institution working through its board, investment and finance committees and staff has a significant challenge in meeting their fiduciary role and responsibilities in overseeing the selection and monitoring of their OCIO provider. This is becoming more difficult given the growth in the number of firms providing OCIO services and the complexity of their solutions.

The Endowment Model (most associated with Yale) of asset allocation and investment selection is well known. It involves the heavily-weighted use of alternative asset classes, direct and illiquid investments, and limited use of core asset classes, which are usually indexed. At times this approach like any investment approach can produce varied results. It certainly provides complexity to the OCIO oversight.

But what if this approach is not entirely the best fit for your institution. Let's take a look at some investment themes and trends that apply more universally.

## WHAT'S IMPORTANT HERE AND WHY?

OCIO providers usually operate on a discretionary and fiduciary basis. This means they have control over and responsibility for the selection and monitoring of the investments. However, the institution, primarily through its investment policy statement, dictates the asset allocation, permissible investment strategies and vehicle types. This includes assessing the following:

### What is the appropriate asset allocation?

The basic tenets of asset allocation remain alive and well. It's not necessary to broadly eschew more traditional asset classes in favor of more esoteric choices, especially in a world where correlations are increasingly becoming aligned. Diversification is still the governing principle – get the best from varied options.

- The institution with the help of the OCIO needs to **determine the right mix of asset classes** that provide the potential return and risk levels that match the institution's growth and spending goals.
- What's probably more important is to **stress test various allocations** to determine the likelihood of achieving the goals established, and to assess the impact of possible negative outcomes on the institution's goals.

### What is the role of indexing and how much should we use?

Indexing is certainly known for its low-cost approach. It also provides the benefits of managing active risk, that is the risk of manager underperformance. Indexing has a significant role to play in any portfolio, but it is important to consider the right fit of passive investing.

- OCIO providers often say they use indexing narrowly in efficient asset classes, such as large cap U.S. equities, but active management in less efficient areas like small caps and foreign stocks. There are still benefits of indexing a portion of these other asset classes to manage risks and reduce costs. It's important to establish with the OCIO a macro level view of the use of indexing.

- It's also necessary to carefully choose the benchmarks used. Some are overlapping and, in some ways, opposed, like the overlaps of offering a large cap index (S&P 500) and a broad benchmark (Russell 3000) in the same portfolio. Generally, the broader the exposure the better return/risk trade-off.

## What is active share management and how does it fit?

OCIO providers frequently state a preference for high active share management. This means selecting managers who run more concentrated portfolios of positions they have high conviction in. This approach avoids managers who stay closer to their benchmarks, which can be accomplished via a lower cost index method.

- While this philosophy is a complement to indexing, these approaches usually have higher levels of volatility, often measured by standard deviation and tracking error. A large position in a short list of names can dramatically impact performance whenever any one name has a period of significant over/under performance.
- Given this volatility, it's especially important to understand the portfolio construction, research and risk management approaches of the OCIO.



## What is the role of alternatives and direct or illiquid investments?

As many asset classes become more highly correlated, the use of alternatives, including direct or illiquid investments becomes more appropriate. These provide the opportunity for added return, but more frequently are used for their diversification and risk management benefits.

The issues often raised include understanding their features and benefits and role in the portfolio, obtaining transparency on the fees and assessing their merits, and weighing the trade-offs illiquidity presents versus the still relative newness of liquid alternatives. They certainly introduce much higher levels of complexity and need for due diligence.

- **Alternatives come in different strategies.** They can range from exposure to real assets and commodities, to private capital markets, to hedge funds. Hedge funds in particular are receiving extra scrutiny to determine their value relative to fees. Gone may be the day of multi-strategy hedge funds in favor of more targeted approaches, like managed volatility or long/short.
- **Alternatives come in different forms.** Exposure is often provided in fund-of-funds for modest size plans, which provides diversification and access that would otherwise be less available. They also come in direct investments for larger investors, which then comes with added documentation, oversight and trading and reporting complexity. They can come in mutual funds, common funds, limited partnerships and direct holdings. The specific structure will produce different levels of liquidity and fee structures.

Clearly given all the choice and complexity in the alternatives area particularly, each institution working with its OCIO needs to carefully have, document and implement a strategic view around alternatives and then have the OCIO do exemplary due diligence around the specific execution.

## What about implementing ESG?

The approach to socially aware investing has evolved significantly. We have evolved from simply eliminating offending exposures, to be more focused on the benefits of environmental, social and governance aware approaches. There are also approaches involving impact investing around given issues to becoming a corporate advocate. Understanding the institution's desired social awareness footprint and how that applies to its investment philosophy is all the more complex and important.

- The OCIO manager is likely to have its views and approach to ESG investing. More importantly, the OCIO needs to be aware of and aligned with the institution's views and goals on this.
- ESG is moving from a screening process to be incorporated directly into the management process of the underlying asset managers. It may not be necessary for the institution to have its own ESG mandates, while having this still be part of the management approach of the specific managers.

## CASE STUDY / APPLICATION

PlanPILOT believes in carefully assessing these various components of the investment approach and works with institutions to define, document and implement the best method for each institution. This needs to be done in the beginning of an OCIO relationship and on at least an annual basis.

**Indexing, active management and alternatives all play roles in endowment portfolios. The right mix needs to match the institution's objectives and comfort with the levels of risks and fees. This is likely to happen only if we define them upfront and re-visit them throughout the process.**

- We find sitting down together with our clients and walking through our goals and information gathering survey at the beginning of a search process produces better results. It's useful to **define** where we are headed before we start moving forward. It takes some time and effort to accomplish, but it is well worth the effort.
- When doing our searches, we carefully **explore** these various areas. OCIO firms have different views on these topics. We ask questions to identify the OCIO that is most closely aligned with the specific institution's goals. We want the relationship to be a win-win, but entirely centered around the institution.
- We **request** the OCIO firms to provide a specific portfolio sample, including liquidity levels and full transparency of fees. Board, committee and management persons are better able to make an assessment when they can visualize the solution set.
- There is no perfect or specifically right answer, but we want to get to a **well-aligned solution** that will be workable for the long-term.

**With that knowledge obtained and assessed, the key step is to document this in the investment policy statement (IPS).**

- The IPS should **identify** the investment objectives, permissible asset classes, thoughts on investment styles and vehicles, benchmarks and the risk management goals and measures.
- More specificity is likely to **produce** better results. It takes time and effort, but again is well worth the effort.
- The IPS should be **re-visited** annually to make sure it is still appropriate. It's more than a document, it's the game plan for the OCIO to execute the desires of the institution.

**Of course, all the planning and documenting is only going to be as good as the execution.**

- It's important to **review** the OCIO's reports and meet regularly. We suggest meeting at least semi-annually to maintain an awareness of the program's status. These check-ins should be more than a check-the-box exercise. Take time to assess the information. If anything is unclear, push the OCIO to generate the necessary understanding.
- It's also beneficial to do periodic **benchmarking** of the OCIO's services and fees to peers. We advocate benchmarking to peers every 3-5 years, and a more formal review process every 5-10 years.
- Implementing a well-defined **oversight** process increases the likelihood of obtaining the intended results.

## CONCLUSION

The familiar Endowment Model of asset allocation and investment selection is well known. But this approach may not entirely be the best fit for your institution. Defining, documenting and implementing the approach that aligns best with your institution's goals is the process we assist with to increase the likelihood of achieving your objectives. This serves the institution to improve the management of its fiduciary roles and be the best stewards of its valuable assets.



Let PlanPILOT guide you through the time and effort-consuming process of selecting or evaluating an OCIO provider.

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