PlanPILOT | Better Outcomes, Less Risk

OCIO MYTHS DEBUNKED

Return Vs. Risk Trade-Offs in OCIO

Institutions with long-term asset pools face challenges in setting realistic expectations and managing spending plans. We review the long-term versus short-term return and risk trade-offs that we observe institutions have about the OCIO model and how to effectively address these concerns to produce better outcomes.

Return Vs. Risk Trade-Offs in OCIO

EXECUTIVE SUMMARY

The outsourced chief investment officer ("OCIO") model continues to expand in its adoption and complexity. PlanPILOT's goal is to make this complex subject easier to understand and successfully implement. In this series, we review various myths and concerns that we observe institutions have about the OCIO model. Throughout, we offer suggestions on how to overcome the obstacles to a successful OCIO relationship.

In this paper, we review the long-term versus short-term return and risk trade-offs. Items that give pause in this area include: managing the return targets for the long-term, and managing the risk of shortfalls in the short-term. Thoughtful execution with the aid of a consultant as discussed below can lead an institution through these challenges to better outcomes.

REALISTIC LONG-TERM RETURN EXPECTATIONS

While the markets have been on an upward trajectory since shortly after the 2008-2009 financial crises, returns overall have been below historical averages. This creates challenges for institutions with long-term asset pools in setting realistic expectations and managing spending plans accordingly. This includes:

- **Setting Realistic Return Expectations** – most strategists expect single digit returns across most asset classes over the next five-to-ten years. Investors need to take a sober look at the potential for growth. The future may simply not mirror the longer-term past.
- **Chasing Higher Return Potential** – some private assets and alternatives have higher forecasts. This is often predicated, though, on obtaining the returns of the top-tier managers. To do that, the institution needs to have access to them. These investments also create additional risks that need to be considered.
- **Re-visiting and Re-setting Spending Targets** – given the forecast asset class returns, expected portfolio returns aren't likely to be greater than single digits. This may not be enough to cover traditional spending targets of 4% or greater + inflation (e.g. 2%) plus administrative fees (e.g. 1%).
- **Impact to the Institution** – the potential mismatch of returns with spending goals needs to be considered. Plans set in the past may have to be adjusted for the new normal environment.

Another point of view considers:

- Having a realistic outlook is imperative. Credible OCIO's will be able to provide more honest assessments of the return potential over the next five-to-ten years.
- Diversification into private assets and alternatives requires the identification of the highly qualified managers most likely to generate the anticipated returns. This requires having access to the managers, especially when they are private vehicles or closed to new investors. OCIO firms that manage at more substantial levels will have the access that an individual institution likely will not, and at more attractive levels of fees given their purchasing power.
- Spending targets should be re-visited and re-set for the new environment. This then needs to be communicated within the institution to create realistic expectations amongst board members, senior management, internal staff, donors and the persons who benefit from the institution's services.

SHORT-TERM RISKS

While most asset pools are viewed for the long-term, in fact some in perpetuity, risks can and do exist in the short-term. Markets do not always go up; they do have downside risks. These short-term risks affect the hear-and -now spending of the institution. These include:

- **Employing Risk Management Tools** – many risk management tools are available. Too often, however, managing risk begins and ends with a simple volatility measure like standard deviation. Standard deviation is really only a meaningful measure of a larger population set.
- **Other Measurements Available** – there are many other risk measures available that are better at shorter-term assessments. Unfortunately, these are often ignored, and their value is lost.
- **Knowledge Base of the Decision Makers** – not all decision makers and other interested parties are financial professionals. Various risk tools can be complex to understand. Choosing which to use and how to use them is complicated.
- **Preparing for Shortfalls** – planning for how to respond to shortfalls is better done before they happen. Decision-making as events unfold can be emotional. Anticipating the impact of downturns on spending before it happens is much wiser

Taking a fresh look involves:

- Experienced OCIO's will be able to offer up, explain and implement various other risk measures. These may include downside risk, maximum drawdowns, value-at-risk and Monte Carlo simulations. Having an expert able to calculate and apply these tools is of extreme benefit.
- A valuable OCIO will be able to educate the decision makers on these tools so that they can be utilized in effective manner.
- Planning for shortfalls over short-term time periods is best done in advance. This may involve deciding to calculate spending on rolling-period averages, cutting back on spending during the affected period and building-up excess reserves during better market environments for maintaining spending in the more challenging times.

PRODUCING BETTER OUTCOMES

Constructive outcomes for the institution on these matters can be attained by:

- Selecting and working with **an OCIO who is highly competent on thoughtful return forecasts and risk management tools** is imperative. An institution needs an OCIO who can think and apply effectively the return potential and short-term downfalls of a given portfolio, as well as setting realistic spending plans.
- Having a **well-written investment policy statement** will properly define the risks to be measured and the steps to be taken when they materialize. It is highly important to spend enough time early on with this document and its contents to avoid decision making in the emotional environment of losses.
- **Communicating and engaging effectively internally** with the various interested parties will achieve necessary buy-in with the specific return, risk and spending targets adopted. These persons can include board members, senior management, internal staff, donors and the persons who benefit from the institution's services. It is important to have everyone on the same page for moving forward under more difficult environments.
- A **consultant skilled in OCIO oversight** can be an invaluable ally. A consultant with expertise in this area will develop in-depth knowledge of your institution, have broad familiarity with the firms, return expectations and risk measures available, and be effective at matching your goals and needs aligned with the OCIO you work with.

CONCLUSION

As the investing world continues to evolve into a new normal, it is important that an institution with long-term asset pools review the long-term return potential of its portfolio realistically, and consider the short-term risk possibilities on its spending practices. Institutions benefit by working with a highly skilled OCIO able to assist thoroughly in this on-going assessment. Effective oversight serves the institution in meeting its fiduciary responsibilities and being the best stewards of its valuable assets. This in turn can lead to better donor relations and development opportunities.

Having an independent consultant lead the oversight process ensures objectivity and expertise. Thoughtful process championed by an expert leads to better, intended outcomes.

Call (312) 973-4911 for more information or guidance on managing your OCIO services or visit www.planpilot.com/ocio.

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