PlanPILOT | Better Outcomes, Less Risk

OCIO MYTHS DEBUNKED

Doing Good vs Doing Well in OCIO Management

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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 case study, we review the debate over doing good via social investing versus doing well from an investment return and risk perspective. Items that give pause in this area include how to approach doing good, such as exclusionary screening or constructive evaluation of environmental, social, governance and quality measures, and the respective portfolio impacts of implementing these. Thoughtful execution with the aid of a consultant as discussed below can lead an institution through these challenges to better outcomes.

EXCLUSIONARY SCREENING

Many institutions have missions they are on focused on. These are often educational and service oriented in nature. Conversely, this focus can also mean avoiding certain matters deemed contrary to the mission. Balancing this includes:

- **Furthering the Mission** – many institutions, especially those of a religious nature, often want to encourage bringing about social change. This can be translated into investing in certain areas that are more mission focused, like alternative energy sources.
- **Avoidance** – many institutions, again especially those of a religious nature, often want to bring about social change by avoiding certain areas. This can mean excluding investments in areas like those that produce weapons, are not pro-life or support lifestyles not considered favorable like gambling or tobacco.
- **Moderation Vs All-or-Nothing** – institutions vary in their intensity of application. Some are willing to tolerate de minimis exposures in these areas, such as by setting thresholds on revenues or profits from these items. Others take a harder line view and exclude any exposure.

Another point of view considers:

- OCIO managers vary in their ability to implement these goals. Some openly embrace screening, while others generally seek to avoid it. Depending on the importance of this to the institution, this will steer the evaluation of the OCIO.
- There are different ways of accomplishing this. There are various index investing solutions available, but these are a one-size-fits-all approach. Custom solutions through separately managed accounts may be necessary to fine tune the application. Again, this can influence the choice of the OCIO depending on their available solutions set.
- Not all asset classes are able to implement the screens. Private equity, real asset and hedge investing in particular are not likely going to be able to be in-line with the focus here. This needs to be considered by the institution.
- The doing good versus doing well trade-off can be real in this area. Excluding investing in companies by definition will produce a portfolio that is different than the benchmark representing that asset class in its holdings and characteristics. This will produce some different return and risk results, which can be a plus or minus at varying points in time. This too needs to be understood by the institution.

EVALUATING ESG & QUALITY

An increasingly mainstream approach to doing good is to evaluate companies in a more constructive manner. Analysis can be done of a company's approaches to environmental, social and governance matters (ESG). The belief of many investors is that running companies in these positive ways, often described by the term "quality," promotes doing good and doing well. Thoughts here include:

- **Environmental** – screening can be done on how well a company addresses environmental matters. This may include limiting green-house emissions, water usage and recyclability of its products and waste.

- **Social** – evaluation can be performed on how well a company treats people. These can include its workforce, such as diversity and inclusion practices, and workplace safety. It can also include its customers, such as no customer injuries from the use of a product.
- **Governance** – analysis can be completed on a company's structure and operation. This includes diversity and inclusion on its board and senior management. It also involves good practices around executive compensation and anti-competitive or anti-takeover provisions.

- **Quality –** many managers will describe these considerations using the term "quality." Quality companies can also be evaluated on financial metrics, such as revenues and profitability. The belief of many investors is that higher quality companies as identified in this manner produce better results.

Taking a fresh look involves:

- OCIO managers again vary in their ability to implement these goals. Some openly embrace the use of ESG and quality screens, while others generally seek to avoid them. Many investment managers incorporate these items right into their research process, while others largely ignore them. Depending on the importance of this to the institution, this will steer the evaluation of the OCIO and the underlying managers.
- There are different ways of defining these measures. Custom solutions through separately managed accounts may be necessary to fine tune their application in a manner the institution considers appropriate. Again, this can influence the choice of the OCIO depending on their available solutions set.
- Not all asset classes are fully able to implement the screens. Private equity, real asset and hedge investing in particular are not as likely going to be able to be in-line with the focus here. This needs to be considered by the institution.
- The doing good versus doing well trade-off can be more positive in this area. Any number of studies are concluding that positive ESG and quality measures are positively correlated with producing constructive return and risk results. This too needs to be considered by the institution in setting its investment approach with the OCIO.
- Tying ESG and quality together with exclusionary screening, many managers will attempt to do both to support an institution's mission. This can accomplish various goals, but is also likely to produce less predictable outcomes.

PRODUCING BETTER OUTCOMES

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

- Selecting and working with **an OCIO who is well versed on social screening, ESG and quality measures**, , as well as the effective implementation through passive and / or custom solutions, is imperative. An institution needs an OCIO who can provide potentially rewarding investment options at reasonable levels of fees that also further the institution's mission.
- Having a **well-written investment policy statement** will properly define the screens to be used and the expected returns and risks that follow. It is highly important to spend enough time early on with this document and its contents to accomplish the lion-share of the investment decision making.
- **Communicating and engaging effectively** internally with the various interested parties will achieve necessary buy-in with the screening methods selected and implementation decisions made. 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 with the program.
- 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 and their approaches and be effective at matching your goals and needs aligned with the OCIO you work with.

CONCLUSION

The debate over doing good via social investing versus doing well from an investment return and risk perspective continues. Whether the approach includes exclusionary screening or constructive evaluation of environmental, social, governance and quality measures, the respective portfolio impacts need to be carefully evaluated. Institutions benefit by using a formal due diligence process for OCIO selection and on-going monitoring that will engage an OCIO that will further its mission. 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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