PlanPILOT | Better Outcomes, Less Risk

OCIO MYTHS DEBUNKED

One-Size-Fits-All OCIO Implementation

While the focus of investors tends to be on choosing investment managers and security selection, it has been well documented that asset allocation is really where the rubber meets the road. The asset allocation defines the return and risk potential of a portfolio much like the revolution and orbit of the earth define days and seasons.

PlanPILOT

One-Size-Fits-All OCIO Implementation

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 continued applicability of the so-called endowment model. Items that give pause in this area include the role of asset allocation, the growing use of passive investing and the best use of alternatives. Thoughtful execution with the aid of a consultant as discussed below can lead an institution through these challenges to better outcomes.

ASSET ALLOCATION IS ALIVE AND WELL

While the focus of investors tends to be on choosing investment managers and security selection, it has been well documented that asset allocation is really where the rubber meets the road. The asset allocation defines the return and risk potential of a portfolio much like the revolution and orbit of the earth define days and seasons. Concerns in this area includes:

- **90% Defined** – numerous studies have documented that asset allocation determines 90% of the return and risk profile of a portfolio. Asset allocation is usually set for the long-term and only periodically re-visited (e.g. annually at most frequent; every two or three years is more common). Sufficient time and effort needs to be committed to locking-down the 90%.
- **The Other 10%** – choosing managers and security selection account for the remaining 10%. Yet, the lion's share of focus of investment oversight is spent here. One could argue that too much time and effort is committed on this portion of an asset pool's oversight.

Another point of view considers:

- A thoughtful OCIO will spend significant time on the asset allocation analysis. This includes the asset classes to be used, as well as the return potential and risk profile that results. Spending plans should be based almost entirely on this alone. The amount of time and effort spent here should simply be as much as necessary to define the portfolio and make appropriate plans.
- The asset allocation and its potential impact exists only on paper, however. Strategic decisions need to be made about how to implement the asset allocation. The application of the strategy can make or break it. The choice of active versus passive investing, the use of alternatives and the selection and monitoring of managers is critical, as well.
- Both the asset allocation and manager oversight process should be carefully defined and documented up-front, and then re-visited periodically.

PASSIVE INVESTING IS HERE TO STAY

While debate continues on the use of active versus passive investing, passive investing continues to expand in its usage. Some investors are largely biased to use one or the other, but in reality, there is a place for both in a well-structured investment portfolio. Thoughts in this area includes:

- **Benefits of Passive** – passive investing or indexing locks-down the characteristics, returns and risks of the asset class benchmark it is mirroring. Passive investing will not underperform its benchmark nor increase the risks. This facilitates the implementation of the asset allocation decisions. Passive investing is also significantly lower priced than active.
- **Downside of Passive** – the primary downfall is the inability to outperform the benchmark. To some investors that is leaving money on the table.
- **Benefits of Active** – active investing has the ability to outperform its benchmark. It can do this through sector and security decisions. Active management also historically adds value by avoiding downside risks.
- **Downside of Active** – active investing runs the risk of underperforming its benchmark. The decisions made increase the risk profile of the portfolio. This may defeat the implementation of the asset allocation decisions. Active is also significantly higher priced than passive. Active investing is already set-back in accomplishing its goals by its higher fees.

Taking a fresh look involves:

- Passive investing, at least in core asset classes of public equities and fixed income instruments like TIPS, should be considered the baseline of asset implementation decisions. Locking down the 90% of the return and risk profile needs to be the main goal of constructing the portfolio and passive is largely how that is done.
- Active investing can be used in inefficient asset classes, such as international securities, private investments and alternatives. In fact, it is likely the only way to invest in these areas. Managing return and risk trade-offs becomes imperative.
- Despite this, many OCIOs have a strong bias toward passive or active and may resist use of the other. This simply makes no sense. **OCIOs too biased here should be avoided.**

RE-CONSIDER THE USE OF ALTERNATIVES

Alternatives typically offer greater return potential. They are the mainstay of the endowment model used by the largest investors. Investing in alternatives adds to the complexity of a portfolio, however. Issues here include:

- **Returns Can Be Fleeting** – private assets and alternatives usually have higher return potential. This is often predicated, though, on obtaining the returns of the top-tier managers. 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.
- **Too Much Money Chasing Too Few Goods** – this is the traditional definition of inflation. As some alternative asset classes have grown in usage, the amount of cash committed but uninvested has significantly grown. This puts pressure on the managers to source new ideas. Some will succeed, while some will not.
- **Risk On or Off** – in traditional asset allocation modeling, alternatives may diversify risk by having non-correlated returns with public markets, thus improving the overall characteristics of the portfolio. These investments also create additional risks that need to be considered and evaluated, however. Liquidity and the lack of transparency are the greatest added risks.
- **Expenses** – simply stated, the expenses in this area are higher and less transparent than public markets, and much greater than passive investing. Like active investing, alternatives managers are already set-back in accomplishing their goals by the higher fees.

Seen another way:

- Alternatives are beneficial, at least in their design if not always in their execution. There is a place for them in almost any portfolio, but no institution should feel compelled to use them to simply follow the herd. Strategic analysis by a credible OCIO is necessary to find the right fit for each investor.

- OCIO firms that manage at more substantial levels of assets will have the access that an individual institution likely will not. Qualified OCIO firms will also have access at more attractive levels of fees given their purchasing power.
- Carefully selecting the OCIO is necessary to increase the chances of accomplishing the goals of using these investments.

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 asset allocation and effective implementation** through passive, active and alternatives investment selection is imperative. An institution needs an OCIO who can get them the access to potentially rewarding investment options at reasonable levels of fees.
- Having a **well-written investment policy statement** will properly define the asset allocation, the expected returns and the risks to be managed. 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 specific asset allocation 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 continued applicability of the so-called endowment model needs to be carefully evaluated in light of the role of asset allocation, the growing use of passive investing versus more traditional active and the best use of alternatives. 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.

PlanPILOT

Contact

PlanPILOT
223 W. Jackson Blvd., Suite 800
Chicago, IL 60606

(312) 973-4911
info@planpilot.com
www.planpilot.com

Copyright © 2020. PlanPILOT, LLC. All Rights Reserved.