OCIO - WHITEPAPER –DISCERNING THE ROLE OF QUALITATIVE V. QUANTITATIVE ASSESSMENTS IN OCIO DUE DILIGENCE AND OVERSIGHT

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PlanPILOT

EXECUTIVE SUMMARY

Oversight of the management of institutional asset pools, including foundations, endowments, corporate assets and reserves, is becomingly increasingly complex and challenging. The events of 2020 expanded the need to have rock-solid fiduciary oversight in place. More institutions are looking to service providers, such as due diligence consultants, to assist in meeting these responsibilities relative to their OCIO management and monitoring.

There is a significant difference in the approaches of due diligence. The more traditional focus relies heavily, sometimes exclusively, on quantitative measures. Quantitative measures usually focus on returns and fees. While these are important of course, they contain substantial limitations that can impair effective OCIO due diligence and lead to poor outcomes.

An effective approach focuses more on qualitative factors, such as relationship, the process and structures in place to determine strategic asset allocation, portfolio implementation and risk management, and the scope and quality of services available. This still incorporates quantitative factors to be sure, but in proper measure and for the right reasons.

We identify and discuss these various qualitative and quantitative factors in this paper. We make the case that a more wholistic approach is needed to ensure effective OCIO oversight.

ELEMENTS OF EFFECTIVE QUALITATIVE ASSESSMENTS

While OCIO oversight can take many more forms, an effective approach focuses more on qualitative factors, such as the quality of the relationship, the process and structures in place to determine strategic asset allocation, portfolio implementation and risk management, and the scope and quality of services available. These aspects can determine the ultimate success, or not, of the OCIO relationship, which in turn will be reflected in the quantitative measures.

OCIO IS FIRST AND FOREMOST A RELATIONSHIP

There is a saying that no one cares how much you know until they know how much you care. At its core, an OCIO assignment involves an institution granting discretionary authority over its mission critical assets to an external party. This decision needs to be made initially and reviewed on-going carefully.

Key Stakes

- OCIO relationships will last a minimum of 3-5 years before the decision to continue with the firm is reviewed
- Good OCIO relationships will last much longer
- As the assets being managed are critical to the success of the institution's mission, the OCIO's approach to asset management, as well as how it manages its business overall, needs to be well aligned with the institution
- The OCIO may be involved in donor education and fund raising activities, and so needs to be a good fit with the institution's benefactors
- As matters such as good social and governance practices, and diversity and equity approaches, become more important and implemented, an institution will want to partner with an OCIO who shares similar points-of-view

Key Considerations

- Explore the scale and experience of an OCIO provider in working with similar types of institutions to anticipate their ability to relate to your institution
- Ask them to identify their key differentiators, which will reveal what they hold important
- Review the educational and governance support they provide to learn how well they will partner with you
- Assess the donor support services expected and determine your comfort with the OCIO being in front of your donor base
- Identify the frequency and scope of customization in their proposal and presentation, which will reveal the time they will take to get to know you
- Check their references and gauge the level of their enthusiasm and support for the OCIO

STRATEGIC ALLOCATION IS STILL THE PRIMARY DECISION TO GET RIGHT

It has been well established in the asset management industry for decades that asset allocation is the primary determinant of a portfolio's return potential and variability (i.e., strategic decisions), with manager selection, security selection and market timing (i.e., active management) playing only minor roles. Some estimate strategy accounts for as much as 90%. It is fair to assume then that institutions and their OCIO managers need to focus on this part mostly and make sure to get it right.

Key Stakes

- Asset allocation and modeling are only as good as their inputs, which usually come from the OCIO's research and strategy decision
- Lower forecast returns and greater volatility are common outlooks
- Models drive the analysis, but people drive the construction of the models
- People make the implementation decisions

Key Considerations

- It is important to understand an OCIO's methodology behind its economic and capital market forecasts to determine their reasonableness
- Inquire about the construction of the OCIO's models to identify any biases and risks
- Identify who makes the decisions; team based decisions including multiple sources, such as strategy, manager research and portfolio construction, will likely be the best formulated
- Determine the frequency, causes and oversight of revisions to forecasts and how that may shift strategic decisions to more tactical bets

PORTFOLIO CONSTRUCTION AND RISK MANAGEMENT DEFINES THE REST OF THE OUTCOME

An asset allocation only exists in theory. It must be implemented, which is where the rubber meets the road. Decisions must be made on asset classes and sub-asset classes, manager selection and oversight, and risk impacts. This is also where the remaining determinant of a portfolio's return potential and variability (i.e., the remaining 10% or the alpha potential) are established.

Key Stakes

- OCIO firms will have a process and team structure in place for implementing their asset allocation decisions that needs to be understood
- This includes selecting sub-asset classes, such as U.S. versus international exposures, growth versus value styles, as well as fixed income components, such as investment grade versus high yield, sector exposures, and duration targets
- OCIO's have different preferences on the use of active versus passive management, how much active risk is preferred from its managers, the use of public versus private markets, and the

incorporation of alternatives and illiquid vehicles, which the institution needs to understand and be comfortable with

- These different components will produce diverse return potentials that will determine the potential for alpha
- The various exposures will also determine the risk and liquidity profile of the portfolio

Key Considerations

- It is important to understand an OCIO's methodology behind its implementation of its asset allocation and the process in place to identify any biases and risks
- Identify who makes the decisions; again, team based decisions including multiple sources, such as strategy, manager research and portfolio construction, will likely be the best formulated
- The OCIO should be able to provide at least a range of anticipated alpha, the sources of that added return, and the volatility and risk forecasts that result
- The OCIO should be expected to provide various risk measures, including downside risks, value-at-risk, Monte Carlo simulations, upside and downside capture, that will provide reasonable expectations to the institution of its ability to meet its spending targets and prepare for circumstances that will come up short from time-to-time

ASSET MANAGEMENT IS COMPLEMENTED BY SERVICE

While OCIO is first and foremost an asset management exercise, there are other considerations that are also important. Some OCIO firms will provide various complementary services that some institutions will find valuable. These are often included in the pricing.

Key Stakes

- An area that all OCIOs will provide is reporting; this should include more than returns, holdings and transactions
- Donor gifts need to be valued, often sold and re-invested
- Someone needs to provide custodial services; some OCIOs provide this, especially if they are a bank, while others will have preferred relationships
- Some OCIOs will provide or have recommendations on other administrative services, such as donor advised pools, foundation accounting, charitable trust accounting and beneficiary services (e.g., income payments, 1099s), tax reporting and compliance support
- Some OCIOs will offer treasury and credit services, again especially if they are a bank

Key Considerations

- Obtain and review samples of the OCIO's monthly, quarterly and annual reporting; it should include identification of the amount and sources of alpha, broad risk measures, and how these compared to forecasts, benchmarks and peer groups
- Determine and carefully evaluate the custodian as this determines the effectiveness of meeting much of the day-to-day transactional and reporting needs

- Identify the complementary services offered by the OCIO and determine the value to the institution
- Document and assess the fees for these various services

QUANTITATIVE ASSESSMENT IS IMPORTANT, BUT IN PROPER MEASURE

Let's shift and review the quantitative aspects of an OCIO relationship. Many institutions and/or their due diligence consultants invest most of their time reviewing these aspects, with some largely ignoring the qualitative aspects discussed above. This myopic view, which is usually focused on returns and fees, can lead to a disappointing result overall.

RETURNS ONLY TELL PART OF THE STORY

Returns are usually the main focus of due diligence oversight. Returns are important, of course, but they need to be reviewed and assessed in various manners that will tell a much more complete story.

Weaknesses

- Returns are often reported as of a point-in-time, such as 1-, 3-, 5- and 10- year time periods ending as of a given date
- Point-in-time performance can be significantly impacted by the time periods included; for example, including (or not) the first quarter of 2020 versus the following three quarters of 2020 will produce substantially different results in short-term returns
- Many OCIOs report performance for representative accounts and do not construct composites citing the differences in their clients' portfolio construction, which can produce cherry-picking and make comparisons difficult to accomplish
- Some OCIOs use GIPS standards promulgated by the CFA Institute for consistency in their client performance and composite calculation and reporting, but many do not, which again makes comparisons challenging
- The use of policy benchmarks and peer group or industry standards is inconsistent

More Effective Approach

- The impact of a given quarter or year on performance can be mitigated by looking at rolling period returns (e.g., 5-year returns over multiple time periods), which will produce a better view of the consistency of an OCIO's results
- This can also be accomplished using a growth-over-time performance chart
- Performance in bull versus bear markets can also be parsed and examined to identify a manager's strengths and weaknesses in different market conditions
- Ask the manager for its composites and whether they are GIPS compliant, and give a nod to those who are meeting industry standards
- Utilize some standard policy benchmarks and peer group standards for consistency

ATTRIBUTION AND RISK MANAGEMENT MEASURES ARE AS IMPORTANT AS RETURNS

Returns are simply numbers and do not tell a full story. Attribution measures the sources of returns, especially the OCIO's alpha versus beta or factor sources. Risk too is often viewed simply as the volatility of returns, and more complete assessments are commonly overlooked. Returns also may or may not accomplish the institution's overall goals. Quantitative analysis needs to dig deeper than the headline numbers to evaluate these additional aspects.

Weaknesses

- Returns and comparing them to benchmarks and industry standards by themselves fail to identify the sources of them and the risks taken to generate them, as well as their consistency and predictability, which can be much more meaningful
- Risk is so much more than volatility, but includes focus on the downsides and the potential outcomes of various economic and market scenarios
- Comparing returns to financial metrics is necessary, but an institution needs to also assess whether they are meeting their institutional goals and mission
- Understanding fully the potential for returns and risks is essential to effective institutional planning

More Effective Approach

- Assess an OCIO's ability to broadly report on the sources of its returns; the added costs of seeking alpha need to be understood and justifiable
- Work with an OCIO that provides deep risk measures, including scenario analysis that can support your rainy-day planning
- Risk-adjusted returns, including Sharpe and Information Ratios, are a better gauge of a manager's results than the absolute returns or volatility by itself
- Consider an OCIO's ability to measure itself to mission-aligned factors, such as enterprise goals (e.g., spending policy, building reserves)
- All of this requires a much broader and deeper assessment of an OCIO

FEES ARE IMPORTANT, BUT FOR THE RIGHT REASONS

It seems everyone is focused on reducing costs. While that is important, making sure appropriate value is received for the level of costs incurred is even more necessary. Costs are also often multi-layered, and understanding all the components is critical for a full assessment.

Weaknesses

- Fee quotes for OCIOs often starts and stops with the manager's advisory fee, which is incomplete

- There are other layers of fees, including the underlying managers' fees, performance related fees and transaction costs, that are probably substantially greater
- OCIO's may have revenue sharing arrangements in place with underlying managers and fund products that add to their compensation
- When an OCIO uses its proprietary management, this introduces the concepts of conflict of interest and possible double-dipping that need to be reviewed and approved
- There may be administrative services included in the advisory fee or they could be charged separately, and this should be understood
- Custody charges can also be significant and overlooked

More Effective Approach

- Obtain a full and complete assessment of all the components of fees that will be generated on your valuable assets
- An all-in analysis of fees facilitates better comparison amongst OCIOs
- Consider performance based fees that more closely align the interests of the OCIO and the institution
- Similarly, consider service guarantees that help ensure the OCIO's execution is consistent with the standards they promised
- Insist on full transparency and reporting throughout the relationship

CONCLUSION

As is illustrated above, institutions benefit greatly by adopting an effective due diligence process for the selection of an OCIO provider initially and followed by on-going OCIO monitoring. A meaningful approach focuses more wholistically on qualitative factors, such as relationship, the process and structures in place to determine strategic asset allocation, portfolio implementation, risk management, and the scope and quality of services available.

This still incorporates quantitative factors, namely a broad and deep assessment of returns and fees, but in proper measure and for the right reasons. Short-cutting the oversight of the OCIO to more basic returns and the OCIO's fees can lead to poor decision making and ineffective planning.

At the end of the day, thoughtful process leads to better, intended outcomes. Effective oversight serves the institution in meeting its fiduciary roles and being the best stewards of its valuable assets. This in turn can lead to better operations, strengthening donor relations and development opportunities, and fulfilling the important mission of the institution.

If you would like more information or guidance on OCIO due diligence services, please contact PlanPILOT *at* info@planpilot.com *or* (312) 973-4911 *or* visit our website http://planpilot.com/landing/ocio/