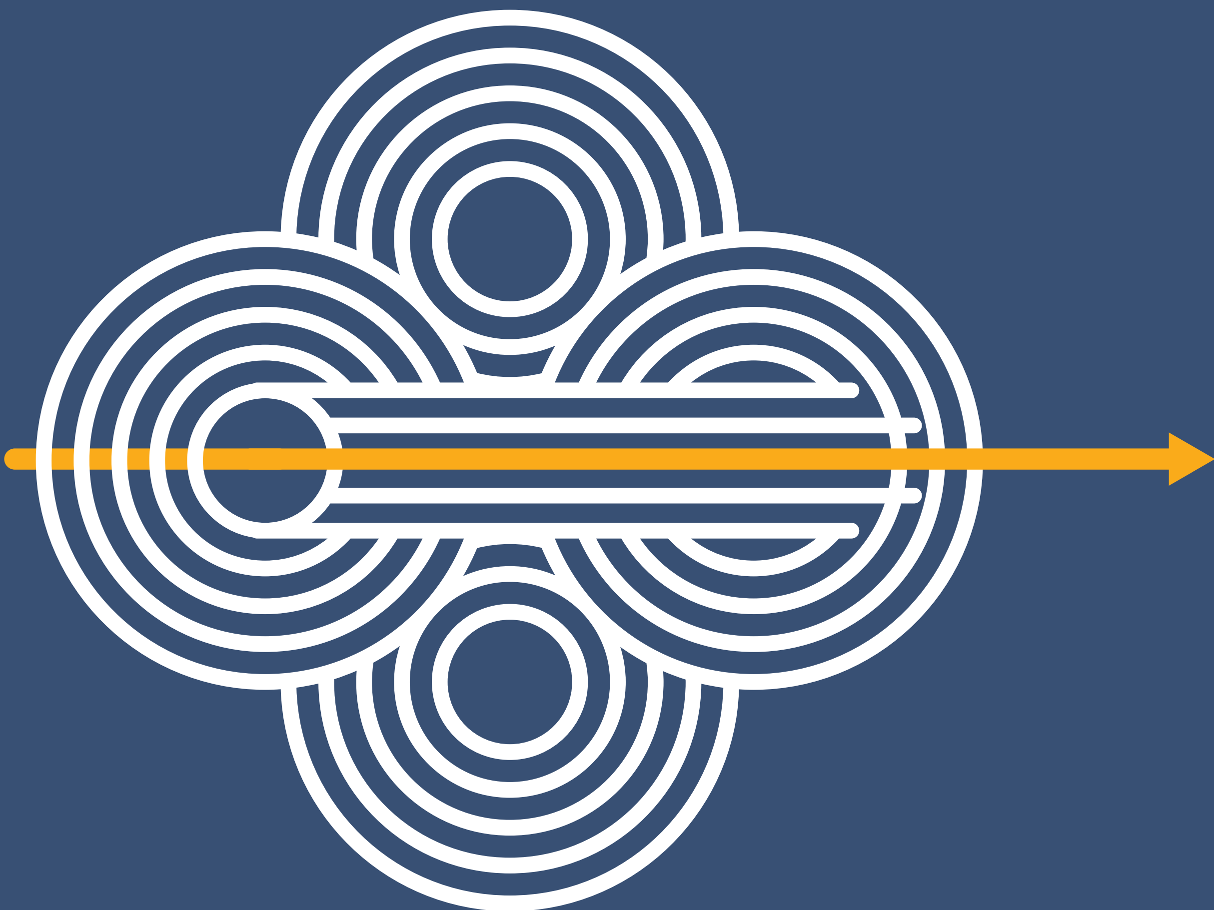
ADVERTISING SUPPLEMENT

OCIO

STEADY HAND AT THE WHEEL



IN THIS ISSUE

P&I CONTENT SOLUTIONS GROUP

This special advertising supplement was not created, written or produced by the editors of *Pensions & Investments* and does not represent the views or opinions of the publication or its parent company, Crain Communications Inc.

For information on participating in P&I Content Solutions projects, please contact Nikki Pirrello at npirrello@pionline.com or 212 210 0224.

TACKLING THE NEW INVESTMENT REGIME

To address greater market volatility and investment complexity, OCIOs are delivering more flexible and nuanced investment solutions that meet specific portfolio objectives

As the financial markets experience waves of turbulence, institutional investors of all types — pension funds, endowments and foundations, health-care organizations and defined contribution plans — are seeking the steady guidance and deep expertise of OCIO providers to help meet their specific portfolio objectives. In today's more volatile and complex market environment, where challenges are compounded by high interest rates and geopolitical risks, outsourced chief investment officer firms, or OCIOs, are delivering flexible and custom discretionary investment management services to institutional investors.

According to a survey of asset owners conducted by Cerulli Associates in 2022, roughly 14% said that over the next two years they would consider outsourcing their CIO responsibilities, and 11% said they would consider expanding their OCIO's role by moving from partial to total portfolio management or by adding other in-house managed-asset pools.[1]

"One of the main drivers for the increased demand for the OCIO model has been the rise in uncertainty," said Bryan Ward, senior partner and head of solutions and sales at Aon. "Over the past three years, volatility has had a significant impact, along with higher interest rates and the prevalence of more sophisticated investment strategies. In this environment of volatility and dislocation, the investment opportunity set has evolved," he said.

"Asset owners are looking for organizations with global breadth, thought leadership and relevant expertise," Ward said. "We take volatility and uncertainty into account and provide road maps for strategies that weather the storms. We strive to build resilience in portfolios."

"As the world becomes more complex, when you look at the needs of asset owners, whether they are corporations, plan sponsors, nonprofits or operating accounts, these organizations are under pressure now. They are using an OCIO program, which allows them to stay focused on their core businesses," said Jeremy France, head of Graystone and institutional consulting at Morgan Stanley.

"Regulatory challenges and market complexities are certainly increasing investment committees' appetite for OCIO arrangements. In addition, thought leadership is gaining prominence as a key component of an OCIO offering," said Jim Link, head of institutional OCIO at PFM Asset Management.

SHARING RESPONSIBILITY

Common to asset owner engagements is an interest in the shared fiduciary responsibility with the external OCIO firm. "Investment boards have a broad mission, whether they are pension funds, endowments, foundations or corporations, and shared fiduciary responsibility [with the OCIO] is an important concept," said Link. "Given the increasing complexity of capital markets, the access to OCIO expertise is essential, from research and strategy development to day-to-day portfolio management and execution," he added.

The OCIO model has clearly demonstrated its value in recent years. "We're seeing a growing interest in services where strategic partnerships are designed to complement the work of internal staffs," said Peter Corippo, managing director of retirement fiduciary solutions at Russell Investments. "We've consciously developed our platform to be flexible so that we're able to integrate and complement those internal resources and deliver on our clients' specific objectives in a tailored way," he said. [See visual below on range of services for investment programs.]

SPECIFIC OBJECTIVES

OCIOs are focused on ensuring alignment between each client's investment strategy and institutional goals across a range of mandates, such as total-return portfolios, liability-driven investments, pension risk transfer and sustainability targets.

"What we're seeing from investment mandates is that clients want diversification, and they understand that it's challenging to find alpha these days," said France. "When we meet with our clients, we look at their spend policy, investment policy and risk metrics. Then we design individualized programs that align with their goals."

"The greatest nuances are with the nonprofits, given their lifespan and risk tolerance. They tend to place emphasis on private markets and alternative managers, in addition to areas like charitable giving, environmental, social and governance and sustainable investing," Link said.

Other types of institutions may have different investment needs and objectives. For instance, several corporate plans that have recently seen improved funded ratios are now more focused on offloading their pension obligations to an insurer via a pension risk transfer, while other corporate plans continue to pursue the liability-driven investment, or LDI, path.

"For LDI, pensions and insurance reserves, for example, tend to be very focused on risk management," Link pointed out. "The public sector world and other kinds of policy-oriented or benchmark-driven investors tend to be less extended into alternatives."

"In the nonprofit world, ESG continues to be a major topic of discussion. For OCIOs, this means helping each client to understand and articulate their needs and preferences," said France. "OCIO has the ability to create the customized portfolios that these clients are looking for, whether they are liability-driven, sustainability-oriented or have a total-return orientation," he said.

EXPANDED FOOTPRINT

"We've seen a continuing trend in the space this year, where larger asset-owner pools have been considering and engaging OCIOs. When the industry started, it was dominated by smaller qualified pension plans: frozen plans from less than $100 million to $300 million were the dominant adopters of OCIO. Now that has expanded not only to include endowments and foundations, but also defined contribution and the public sector," said Ward at Aon. "We're also seeing growth in the larger asset pools. The situation where multibillion-dollar asset owners are considering OCIO is commonplace now."

Ways to Help Organizations Maximize the Potential within their Investment Programs

ACROSS INDUSTRIES

Corporate	Non-profit
Endowment	Educational
Insurance	Financial
Healthcare	Government

ACROSS STRUCTURES

DB/DC	Trusts
Distributors	Custody platforms
Tax exempt	Plan participant
Brokers/Dealers	

Source: Russell Investments. For illustrative purposes only. As of Nov. 17, 2022.

[1] *See P&I, "25% of institutional asset owners considering OCIO in next 24 months — Cerulli," Jan. 24, 2023*

MENU BROADENS TO SATISFY DIVERSE TASTES

Asset owners seek customized solutions and a wide menu of services beyond investment management

Asset owners today are looking for OCIO providers with broad capability and flexibility across passive and active strategies, public and private markets, and physical securities and derivatives. They are engaging OCIOs for full discretionary investment management, partial management of specific asset classes and hybrid arrangements. Beyond the investment piece, OCIO services include governance and administration, as well as education for investment committees and plan participants.

CLIENT-SPECIFIC LENS

"A careful consideration of the type and size of each asset owner is a key differentiator for OCIO services," said Corippo at Russell Investments. "Taking the size of the asset owner into consideration is an important factor in how we develop investment strategies for corporate [defined benefit] plans, spending objectives for nonprofits and participant demographics and employer contribution designs for DC plans." One example of customized service for DC plans is retirement-readiness studies "customized on the front end and revisited as needed during the multiyear relationships that we build with our clients," he said.

"Customization has always been how we start client relationships — with a blank sheet of paper. Naturally, we have building blocks in terms of core asset classes that we use, such as public fixed income, public equities and core real estate. But in terms of strategy, there has always been a clear understanding of client objectives, their risk tolerance and any restrictions or requirements," said Ward at Aon. "Recent areas where we've seen increased customization include the implementation of alternatives and hedging of liabilities in qualified pension portfolios," he added.

"Customization could be something as simple as performance reporting. Depending on the type of client, the treatment of gains and losses may be important because they may ultimately flow through to the balance sheet. Understanding the components that go into portfolio reporting is a key area for service excellence," said Link at PFM Asset Management.

"The requirements around OCIO have grown tremendously, and it's no longer just about the investment lineup, especially for DC. It's providing fee-study analysis, record-keeper reviews, financial wellness and education. Firms understand that OCIOs have the greatest capability because if they're a fiduciary over the entire plan, they have the most knowledge," said France at Morgan Stanley. [See visual on range of discretion given to consultants.]

ESG investing has been another area of customization for OCIO. "We have seven core practice groups within Graystone: professional services, faith-based organizations, health care, strategic retirement, Taft-Hartley, endowments and foundations, and insurance," France added. "The needs within each group are substantially different."

"Faith-based organizations want to ensure that their investments reflect their beliefs. Endowments and foundations also want to

DISCRETION GIVEN TO CONSULTANTS UNDER OCIO

TRADITIONAL CONSULTING
Project-oriented approach driven by the client's needs

CONSULTANTS
Help investment committee make informed decisions on manager search and special studies; provide portfolio monitoring and performance reporting

INVESTMENT COMMITTEE
Responsible for portfolio construction and implementation

PARTIAL DISCRETIONARY
Collaborative approach between the client and consultant

CONSULTANTS
Assist with investment objectives and guidelines; provide portfolio monitoring and performance reporting

INVESTMENT COMMITTEE
Determines which investment decisions require approval

COLLABORATIVE PORTFOLIO MANAGEMENT
Either party can be responsible for portfolio construction and implementation

FULL DISCRETIONARY
Outsourced Chief Investment Officer (OCIO) approach overseen by the client

CONSULTANTS
Responsible for asset allocation, manager due diligence and selection, risk management, and all other day-to-day tasks

INVESTMENT COMMITTEE
Focused on monitoring the big picture rather than day-to-day decisions

LESS MORE

Source: Graystone Consulting from Morgan Stanley

Graystone Consulting
from Morgan Stanley

Our Focus Is on You

One of the biggest investment decisions a board will make is determining how much control they want over managing their organization's assets. But the insourcing vs. outsourcing decision is not an either/or proposition. Whether you want help with a special project, full discretionary portfolio management—or something in between—Graystone Consulting can meet you wherever your needs are.

Learn More

We can help you create financial security for your organization.

graystoneconsulting.com

be assured that their investments match their goals on both financial and philosophical levels. Pension funds need to meet their plan commitments, sometimes long into the future," France said.

A HOLISTIC SUITE

OCIOs find greater interest in a holistic approach encompassing investment management, from setting allocation targets portfolio design and managing the investment through to education, governance processes and regulatory compliance.

"Our OCIO offering has always incorporated Aon's thought leadership, in terms of capital markets and investment opportunities, said Ward at Aon. "On the qualified pension side, the changes in the regulatory environment have a strong influence on our advice and implementation. We have also seen increased demand for experts on the administrative side as part of the client solution," he said.

Thought leadership has extended to providing current and frequent educational material for some pension plans. "The notion of thought leadership being a key component of an OCIO offering is becoming more evident now," said Link at PFM Asset Management. "We have focused on topics that are useful throughout the organization, including emerging asset classes, investment trends and pension accounting rule changes. We have also evolved our educational offerings to include customized training for board members, some of which are Continuing Professional Education credits," he said. [See visual on client communication and education.]

"Graystone Consulting is seeing a fresh focus on education from all kinds of retirement plans, not just defined contribution," said France at Morgan Stanley. Plan sponsors are looking to OCIOs "to deliver information to their participants through seminars, webinars and onsite meetings. We are working to provide a genuine educational experience and helping them deliver the best experience to their employees."

PARTIAL AND FULL MANDATES

Both full and partial OCIO arrangements are growing across the client base. "We see demand for full OCIO once an organization has made the decision to outsource. However, large asset owners sometimes express an interest in customizing their relationship, what we call hybrid OCIO," said Ward.

One of the common arrangements for hybrid OCIO entails the investment approval process. "In some cases, the client may require a final look before a strategy or trade is implemented in the portfolio," explained Link. "But in other cases, clients with very large portfolios may segment the assets, allowing the OCIO to have full authority in the public market and a nondiscretionary or approval-only arrangement for the private market alternatives," he noted.

As with other aspects of the OCIO world, flexibility is key. "We continue to see, in the small- and mid-sized market, clients who are searching for a turnkey-service deliverable, the traditional OCIO. However, there is an increasing awareness that OCIO can come in different packages, from partial to full service; it isn't necessarily a one-size-fits-all solution," said Corippo at Russell Investments.

PENSION PLAN OBJECTIVES

OCIO mandates for pension plans have evolved, as these organizations have become better funded and are able to explore more hedging strategies to reduce overall portfolio risks. Refining the current portfolio objective is the key first step in the OCIO relationship.

"We ask for their stated objectives." said Ward. "Do they want to stabilize or hibernate, manage and maintain, which basically means keep the plan on the books? The other option is to terminate the plan and sell the assets and the liabilities to an insurance company that will assume responsibility for the obligation," he said. "For organizations that have a path towards plan termination, we help them run the last mile, managing the process and risk exposures efficiently."

"Many firms are looking to take fully funded plans, freeze them and then make certain that the investments are protecting them. We explore all the options with them and then match the investments to their desired outcome," said France at Morgan Stanley. "Some of the biggest challenges can arise in a risk transfer process because the portfolio has to stay aligned [with] the investment policy while matching what the annuity providers will need," he pointed out.

COMMITMENT TO CLIENT COMMUNICATION & EDUCATION

PORTFOLIO REPORTS & ALERTS

- ✔ Timely updates on portfolio changes and markets
- ✔ Quarterly meetings and monthly reporting
- ✔ 24/7 online account access

FREQUENT & RECURRING SEMINARS

- ✔ Customized workshops (on-site)
- ✔ Off-site seminars offering Continuing Professional Education (CPE) credit
- ✔ Special webinar offerings to address developing market events

THOUGHT LEADERSHIP

- ✔ Monthly market updates
- ✔ White papers and educational pieces
- ✔ Webinars and other tools

Source: PFM Asset Management

For plans engaged in pension risk transfer, the OCIO can help keep the process on track. "We have the actuarial expertise in-house to be able to assess the liabilities, and they are not all equally attractive," said Corippo. "Some liabilities are in pay status, relatively predictable and hence more appealing to insurance companies. That pricing dynamic is an important factor in a decision on whether to do a risk transfer or [instead] to maintain a well-funded liability and hibernation state," he explained.

Another factor for pension funds grappling with these issues is communication and information flow. "There are many nuances with pension risk transfer, and it's important for plan sponsors to remember that the OCIO should be kept in the discussion with the actuary and other parties involved. Once you decide to go down the plan-termination route, the lines of communication must be kept open," said Ward.

MANAGING RISKS

Pension funds can vary significantly by structure and circumstances, which requires an individualized approach to plan management. "We take a holistic view on total plan assets in relation to liabilities, rather than simply matching bond investments to projected pension benefits," said Link at PFM Asset Management. "We see liability driven investing as a risk-management situation, not a source of excess return for the plan. It should be high-quality selection, minimizing tracking error to a liability benchmark. LDI tends to be a highly customized solution," he said.

With thought leadership in demand by all asset owners, pension funds also need comparative market intelligence. "Russell Investments recently published a report that combed through the 10-K filings of very large plans and provided a distilled analysis of market trends and funded status, asset allocation, discount-rate movements and what plan sponsors were doing with their sector contributions," said Corippo. "It helps management teams to ensure that their plans are being managed appropriately and enables them to do some benchmarking."

RIDING THE LONG WAVE

Asset owners are turning to OCIOs for alternative assets and private markets, with manager selection and performance measurement as key aspects

The demand for alternative asset management from OCIOs is underpinned by asset owners' need for returns that can outperform traditional assets over the next decade. Many continue to explore OCIO engagements that can provide a range of alternative and private strategies as well as multi-asset and multi-manager portfolios.

"OCIOs provide essential guidance in manager selection and risk management for multiple-manager structures, helping to ensure that investment results are meeting the client's overall expectations. Looking across asset classes, simplifying access to private investments could play a key role in diversifying multi-asset portfolios," said Corippo at Russell Investments.

"We spend a large amount of time on manager selection and allocation, so having tools to see the allocations on a granular basis and adjusting them periodically helps to avoid surprises for our clients," Corippo said. "Having a [due diligence] plan is crucially important, because those allocations, by their very nature, take time to build and manage as they become mature and start to distribute. In addition, maintaining the allocation will require new commitments. Setting expectations is important with respect to managing alternatives in a total-asset environment," he added.

"As always, ongoing risk management is a key area of focus," said France at Morgan Stanley. "Not only are we looking at expansion within asset classes but, more importantly, we're looking at stress-testing the portfolios and making certain that as market conditions change, we're able to plan accordingly and help protect through diversification. We want to ensure that we're taking advantage of opportunities while also helping to protect assets in both upside and downside markets," he added.

ALTERNATIVES FOCUS

Access to the appropriate alternatives managers is a key consideration. "There are two trains of thought on alternative investments. One is focused on pooling client assets and creating a fund of funds structure, which can be done by the OCIO with the help of other providers of fund services. The other strategy is more direct — going to the alternatives managers themselves," said Link at PFM Asset Management. "We focus on identifying individual managers in the manager universe that fit into an asset allocation approach to alternatives and evaluate those managers and their funds based on track records and experience, just as we would for a public security. The issue is that private investments typically tend to be seven to 12 years in duration, so there are special considerations in this area," he noted.

Aon's Ward emphasized the need for specialized expertise: "If we're looking at alternatives and private markets, that's a very different landscape than the public markets," he said. "OCIOs can identify opportunities and strong managers and put assets to work through understanding the dynamics and how those markets operate. In this way, they can help clients move into or expand in this space in a confident manner," he explained.

MANAGER DUE DILIGENCE

Across all asset classes, manager selection is a key part of the OCIO advantage. "Our manager research and selection process is a global process set up by asset class: public equity, public fixed income, liquid alternatives, real assets and private markets," said Ward. "We look for differentiated sources of alpha through managers that complement each other," he said.

"Russell Investments has integrated ESG as one of many factors in the mosaic of metrics that we monitor," said Corippo. "It's both quantitative and qualitative, and we do the due diligence ourselves. We also monitor, through a periodic survey, our asset managers on how they're viewing its contribution compared to other drivers of their success. We share that information broadly with the community."

A critical aspect of manager selection is evaluation of past performance and predictions for the firm's future success. "If we're looking at active managers, we try to decide how trustworthy the statistics are by analyzing the managers actions," said Link at PFM Asset Management. "We look at areas like return and risk statistics, but where due diligence really takes place is in questioning the manager on their process and how they think about managing portfolios. With newer firms, in particular, we have to pay close attention to operations, compliance and other aspects of the business beyond the pure investment management component," he said.

"In spite of the occasional challenge with newer managers, OCIO firms find that they represent attractive opportunities," said Morgan Stanley's France. "We believe diversification of asset classes and diversification of managers is equally important. To that end, we look at diverse managers, women-owned and minority-owned managers, so that we're getting a wide array of thought leadership in our investments. We think about manager research differently and get greater coverage of firms that might be running smaller asset pools but have a level of sophistication that meets our requirements."

In some ways, the due diligence discussion turns back to the OCIOs themselves. "Clients continue to seek out OCIO providers who are capable across a broad spectrum of services, and throughout the due diligence process they are making sure that the services they're interested in are robust," said Corippo. "Ultimately, when we get into service delivery, they want a fiduciary relationship and competent, user-friendly and transparent services."

INNOVATION AHEAD

As OCIOs continue to drive innovation in investment management, progress is also being made in streamlining their administrative capabilities and processes. "There's close to real-time information through some brokerages, but there is certainly room for innovation in achieving greater transparency and improving coordination across the parties that play a supporting role: manager, custodian, actuary, accountant, plan administration," Link pointed out.

Another area that needs more attention is for OCIO's to adopt global investment performance standards, or GIPS, as part of their fiduciary duty. "In our view, once you've hired an OCIO, the OCIO is responsible for security selection, whether that be via a separate account manager, mutual fund or exchange-traded fund, and they're responsible for the execution," Link said. "Very few investors would hire a manager of individual securities if they did not have a GIPS-compliant track record. But we're still not there yet in this industry."

"In terms of specialized investment exposure, OCIO managers also aim to deliver continued improvements in the scale and access to alternatives," said France. "In terms of trends, we are seeing greater product availability and finding ways to pick up alpha in very specific areas. By pulling together asset pools that may have lacked scale in the past, OCIO providers may be able to find a better niche for their investments," he added.

According to Corippo, "The most important thing is getting the strategy right for clients, and then being able to deliver on expectations. Simplifying access to private investments is a goal for future innovation in our OCIO world."

"We've gone from an industry that launched serving one type of client, small- to medium-sized, and frozen ERISA DB plans, to serving all asset owner types," said Aon's Ward. "The industry has to innovate its service model, which includes technology and operational infrastructure to accommodate our clients. Going forward, OCIO innovation will be driven, in part, by the demands and requirements of the asset owners."


Russell Investments
WHAT DO YOU CALL OCIO IF YOU AREN'T FULLY OUTSOURCED?
Gain access to more resources and expertise, so you can focus on the decisions most critical to your organization.
INSTITUTIONAL INVESTING IS TOUGH. YOU'RE TOUGHER. WE'RE HERE TO HELP.
russellinvestments.com/heretohelp
EMBRACE THE POSSIBLE™
Copyright © 2023. Russell Investments Group, LLC. All rights reserved. This material is proprietary and may not be reproduced, transferred, or distributed in any form without prior written permission from Russell Investments. It is delivered on an "as is" basis without warranty. AI-29717