

# Should Your Plan Consider an Outsourced Investment Solution?

John Nawrocki and Diane Smola

## RogersCasey Brief

The global financial crisis has left many investors stymied about how to make decisions and what they could have done better. This crisis has forced most foundations, endowments, and other institutional investors to find ways to save money while improving performance and risk management oversight. Investors generally seek the greatest possible return for the lowest possible cost, given their tolerance for risk. With the spectrum of opportunities for structuring a portfolio constantly changing and expanding in addition to the complexity of the investment environment, the primary challenge for investors today is how to optimally align resources to structure the best investment portfolio for their particular objectives. Portfolios can be managed directly by the investor or can be outsourced. An outsourced investment solution may range from a single-manager, single-fund to a multi-manager, multi-fund spanning all asset classes and investment styles.

Outsourced fiduciary management solutions are widely used by institutional investors to help meet the following challenges of fiduciary oversight:

- Limited budget
- Level of internal investment expertise
- Non-core task with significant financial implications
- Wide array of investment opportunities available
- Increased complexity of investment strategies
- Increased volatility in financial markets
- Ease/speed of implementing new/replacement investment solutions
- Increasingly complicated regulatory environment
- Improving risk management oversight

For purposes of this brief, we will focus on outsourced multi-manager investing as an investment solution that provides additional investment structures, funds, or services to help investors meet these mounting challenges. We will first summarize the background of multi-manager investing, then comment on the reasons behind its increasing popularity, and finally, note the advantages of outsourcing fiduciary management through multi-manager programs.

### What outsourcing models are available?

Outsourcing models range from focused outsourcing to full outsourcing, with several hybrid/shared governance options within that range. Focused outsourcing is the delegation of specific asset classes and/or functions to an external provider. Historically, focused outsourcing included manager-of-manager programs, but has more recently expanded to include outsourcing of the investment manager selection function or management of alternative asset portfolios exclusively. In some cases, multi-managed solutions assist investors in accessing hard-to-implement asset classes such as infrastructure, hedge funds, or frontier market strategies. In the hybrid/shared governance model of outsourcing, the investor maintains responsibility for strategic/high-level investment functions, but day-to-day implementation to one or more external providers and receives significant support in making high-level investment decisions. In full outsourcing, the “outsourced CIO” model, virtually all aspects of the investment program are handled by the external providers along with reporting to the investment committee. The investor selects the outsourcing provider and assists in defining parameters, while the external provider is responsible for meeting the objectives of the entire program.

## Background

A range of outsourced investment solutions has been in existence for many years. Figure 1 details important dates and events in the evolution of outsourced investment solutions. Multi-manager programs began with investors reallocating their investments from one balanced fund to three or four, with each investment manager having responsibility for both security selection and asset allocation. With the passage of time and the evolution of investment products, institutional investors moved away from multiple balanced funds toward multiple specialty funds. In hiring multiple investment specialists, each responsible for security selection within their portfolio, the asset allocation decision reverted back to the institutional investor and/or committee. What was once controlled by the investment manager within the balanced fund is now often controlled by committees whose primary responsibilities may be non-investment focused. With significant expansion in the number and type of investment products available, managing an entire investment program currently requires a level of sophistication and resources not always found internally. While multi-manager programs have evolved into more flexible investment solutions that allow the investor or investment committee to control certain aspects of the portfolio, such as asset allocation or portfolio structure, many investors are choosing to outsource fiduciary oversight of investment programs in their entirety.

Outsourced fiduciary management (multi-manager investing) represents a tool to be considered by investors in structuring their portfolios. While some investors manage their portfolios internally, oftentimes, some fiduciary responsibilities are outsourced. The extent to which the fiduciary management is outsourced varies from a traditional consulting role to full discretionary management as detailed in Figure 2.

### Heightened Interest in Outsourcing Investment Solutions

According to the Casey Quirk 2010 Consultant Search Forecast Survey, retirement plans, endowments, foundations, and other large investors are seeking “investment managers with strong capabilities in developed and emerging markets stocks, global equities, hedge funds and fund of hedge funds... [Consultants] predict an increased focus from their clients on inflation-protected strategies in 2010... This year four key themes are expected to drive manager search activity: fears about inflation, which are prompting investors to consider new asset classes; concerns over pension liabilities hiking interest in liability-driven investment strategies; a need to shore up funding gaps, which is reviving appetite for hedge funds; and a continued, rising demand for non-US securities.”<sup>1</sup> These themes call for more diversified portfolios. While diversifying investment portfolios usually results in improved performance and less volatility, the results shown in Figure 3 demonstrate that diversification alone is not the answer.

A good governance process does not necessarily result in an optimal investment decision-making process. Moving from a relatively undiversified to a well-diversified portfolio may result in improved risk-adjusted performance over the long term. However, actively monitoring and managing the mix of investments (and investment managers) on an ongoing basis, rather than at quarterly investment committee meetings, for example, provides the opportunity for more nimble investment decisions and potentially for better risk management and improved performance. In a fully outsourced multi-manager program, the platform manager is able to think outside the box and can add a new strategy/manager to the program without the restrictions of an assigned mandate.

Outsourcing non-core activities has been a popular step in managing businesses through the economic downturn. Outsourcing investment manager selection and monitoring, portfolio transition management and rebalancing, and ongoing performance and risk exposure reporting frees internal resources to focus on core business competencies and investment objectives, including identification and management of cash flow needs, risk tolerance levels, and asset allocation. Further, investment objectives are becoming more complicated. As an example, increased interest and focus on liability-driven solutions necessarily requires outsourcing portfolio management functions, such as liability hedge portfolios and liquidity pools. As such, a multi-managed solution helps the institutional investor to remain nimble with respect to these more complicated needs. It also allows the investor to take advantage of more opportunistic strategies while not increasing internal dedicated resources.

### Size of the Outsourced Solution Market

Figure 4 shows projected U.S. outsourced assets according to Casey, Quirk & Associates. Outsourced fiduciary management in the U.S. totaled \$202 billion in 2009. U.S. institutional outsourced assets are expected to more than double in the next five years.<sup>2</sup> FundFire reported that more than 150 institutions have outsourced at least a portion of their assets over the last year.<sup>3</sup>

## Advantages of the Outsourced Solution

Considering the heightened interest in fiduciary and risk management, we will now focus on some of the core advantages of outsourcing investment solutions.

### **Advantage #1: Cost Savings**

In outsourced fiduciary management products, assets of multiple investors are pooled to achieve lower costs, as the platform manager can negotiate favorable fee arrangements from specialist managers and custodians. Pooling of investor assets also may result in more cost-efficient executions as the transaction sizes are larger. Investors avoid paying the most expensive fees or being closed out of an investment opportunity due to minimum investment thresholds, or specialty custody costs too great to justify smaller investment amounts.

### **Advantage #2: Scale**

Investment pools of all sizes are increasingly considering fiduciary management solutions as internal resources to manage investments have dwindled with the rise in cost-cutting measures. However, size still matters for institutional investors when it comes to meeting the minimums required to invest in all asset classes, and doing so at an appropriate institutional price point.

CEM Benchmarking, a global benchmarking company based in downtown Toronto with clients in the U.S., Canada, Australia, New Zealand, and Europe, has noted the importance of scale in pension fund management. "A 17-year analysis with 4,500 return and cost observations confirmed that large pension funds generate higher net returns than small funds. The net return was higher than could be explained by the large funds' cost advantages alone. For example, \$100-billion funds outperformed \$1-billion funds by an average 0.56% per annum, of which 0.36% was pure cost advantage, and the remaining 0.20% due to other factors."<sup>4</sup>

CEM Benchmarking goes on to provide additional reasons why size might contribute to superior performance. These include:

- "It is easier for larger funds to attract and retain the best internal people.
- Larger funds have better access to the best external money managers.
- have control features and organizational structures that prevent ill-conceived investment strategies."<sup>5</sup>

### **Advantage #3: Investor Resource Management**

Outsourcing investment portfolio management facilitates investor focus on the core driver of investment returns: determining the appropriate asset allocation given investor needs and preferences. Improvements in risk monitoring also lead to better investment decision-making and risk mitigation. Given the market volatility over the last 20 months, financial managers prefer to focus on top level decisions, asset allocation for example, and are eager to delegate responsibility for investment implementation, monitoring, and replacement to an outside expert, understanding this will enhance their return and resource utilization. Time normally spent replacing managers can be focused on higher order decisions such as asset allocation and portfolio construction. This allows investors to develop an understanding of the ever-widening array of asset class opportunities to consider for investment.

According to the table in Figure 5, while the importance of the asset allocation decision cannot be overstated, investment committees rarely allocate more than one-quarter of their meeting time to strategy decisions such as asset allocation. Further, investment committees rarely allocate ample time to consider strategy decisions such as the style/beta risk in their portfolios.

### **Advantage #4: Enhanced Portfolio Diversification**

Outsourced fiduciary management programs can provide greater breadth of investment opportunities to investors. These programs enable investors to benefit from cutting edge ideas, to hire specialist managers, and to access investments they might have otherwise missed due to lack of experience, minimum investment thresholds, structure, custody, or lock-up issues. Due to the delegation of fiduciary responsibility for manager selection to the platform manager, opportunistic investing (the short window of opportunity in the case of TALF and PPIP, for example) becomes possible, as the committee is able to avoid a decision time drag. Investing in alternative assets and frontier markets is also possible because the outsourced fiduciary management product structure can accommodate the custody and lockup issues an individual plan may not be able to handle.

According to a study conducted by Louton and Saraoglu, the more diversified a portfolio, the better the potential for reducing risk without sacrificing return. The study was conducted to determine the relationship between the numbers of mutual funds in an asset allocated portfolio and various measures of diversification benefits. Three possible asset allocation mandates were considered: 1) 75% in equity and 25% in bonds, 2)

50% in equity and 50% in bonds, and 3) 25% in equity and 75% in bonds, over 5- and 10-year investment horizons. The results showed that “regardless of asset allocation weights and investment horizons, holding 10-12 funds in the portfolio instead of the minimum 2 funds as dictated by the choice of 2 broad asset classes, enables the investor to reduce the standard deviation of terminal wealth by about 60%. For all three scenarios, the average terminal wealth level at the end of each investment horizon remains approximately the same as the number of funds increases, indicating that the reduction in standard deviation of terminal wealth can be achieved without a reduction in mean terminal wealth.”<sup>6</sup>

#### **Advantage #5: Investment Manager Oversight**

Implementers of fiduciary management solutions are in the investment management and research business; these individuals have a vested interest in maintaining and building expertise, using best-in-breed analytics and risk management tools, and focusing on current knowledge of investment managers and their strategies. Due to their familiarity with markets and products, they are able to concentrate on optimally deploying the investors’ risk budget by selecting higher alpha investments from the available opportunity set. The outsourced investment solution manager considers not only the skill of a new manager to be included in the program but the appropriate weighting of that manager with other current managers given the residual correlations (i.e., manager diversification benefits). They are also able to employ better risk management technology to understand risk exposures of each strategy and portfolios in aggregate. In short, participants in these programs benefit from the implementer’s skill in selecting and combining complementary best-in-class managers in a sophisticated risk management framework.

According to a 2005 Goyal/Wahal study, left on their own, plan sponsors tend to hire investment managers after these managers earn significant excess returns and, historically, the stronger the pre-hire returns, the weaker the post-hiring returns. When plan sponsors fired managers over performance issues, the excess returns of these managers were positive three years following the decision. For round-trip investment manager decisions made by plan sponsors, on average, post-firing three year returns of the fired managers were generally higher than the post-hiring returns of the hired managers.<sup>7</sup> In addition to the opportunity cost experienced by the plan sponsors, transaction costs associated with transitioning portfolios likely led to even worse results as transaction costs can range from 1-2% to as high as 2-5% for exiting some mandates.

#### **Advantage #6: Nimble Portfolios**

Outsourced investment solutions are designed to optimally combine asset classes and managers in order to capture manager skill while controlling risks inherent in style, and minimizing costs. As implementers of outsourced fiduciary management programs make it their business to employ the best-in-class managers for every strategy, they weigh the costs of switching to new strategies against the expected enhancement to return. This involves knowing operational partners able to migrate between investment portfolios incurring the least expense. As a result, implementers excel at transition management and minimize the switching costs. Their manager selection decisions are the result of unique quantitative and qualitative assessments, minimizing cognitive biases that often lead to poor investment decision-making. With a wealth of research at their disposal, these implementers are able to pull the trigger on manager additions, deletions, and replacements without the delays which may be caused by investment committee presentations and deliberations. In short, less implementation slippage occurs in outsourced investment solution programs compared to traditional institutional investment programs. Implementers are free from the time lags associated with less experienced committees making investment manager decisions based on investment committee meeting schedules.

#### **Advantage #7: Consolidated Reporting and Single Point of Contact**

Many internal staff members spend the majority of their time compiling reports and disparate sources of data as well as communicating with multiple managers without the benefit of state of the art performance measurement, reporting, and risk management tools. Fiduciary management product solutions are user-friendly, providing investment committees with consolidated reporting and a single point of communication for the entire portfolio. Freeing up internal resources from inefficient reporting and monitoring procedures can enable internal staff to engage in more productive activities.

### **Considerations in Outsourcing Fiduciary Management**

Beyond returns-based analyses on the multi-manager product itself, potential investors should review the quantitative analytics used by the fiduciary manager on the underlying managers and the optimal combination of managers in their program. Fiduciary managers should be using best-in-breed analytics to ascertain whether or not managers are adhering to their specified style and risk budgets. Fiduciary managers must also

validate their assessments of manager skill and take action on any early warning signals of deterioration.

Investors should examine the fiduciary manager's qualitative assessment of underlying managers and their investment processes as well as their organizations in order to rest assured that the implementer will identify those managers most likely to succeed. In addition, investors should verify that the fiduciary manager has demonstrated timely terminations of troubled managers, such as those with key staff departures, declining assets under management, or other organizational strife.

Potential multi-manager investors must also consider the fiduciary manager's independence and expertise, including research methodologies and risk management techniques, as well as the product's transparency of fees and flexibility for customization. Fiduciary managers have discretion over investment managers included in the portfolio. The nature of the role dictates a need for freedom from conflict which could arise from receiving any financial remuneration from managers, or having a business incentive for including specific investment managers in the program. Conflict policies and full disclosure of any relationships with investment managers must be provided to investors by the fiduciary manager. Transparency of fees charged by underlying investment managers in the program addresses the potential agency risk of an outsourced fiduciary management program. Independence from the managers in the program facilitates the fiduciary manager's alignment with investors' interests, as does remuneration based on risk-adjusted performance rather than a more traditional project consulting fee model.

As investor needs vary, determining the appropriateness of fit with an outsourced fiduciary management program is critical. Some programs offer customization, and the ability to partially outsource investment management. For example, a plan fiduciary may choose to outsource management of only some sub-asset classes. Programs under which any economies of scale or concessions on fees attained by the fiduciary manager accrue to the investors' benefit provide room for implementer fees without becoming cost prohibitive for investors.

In summary, faced with tight budgets, heightened need for risk management, limited investment expertise and staffing, and primary responsibilities that are not investment-related, outsourcing some portion of fiduciary management responsibilities makes sense for many investors. The extent to which the fiduciary management is outsourced depends on the level and availability of internal expertise and resources. Outsourcing fiduciary management should provide the investor with the advantage of the breadth and depth of full-time skilled investment professionals focused on continuous improvement of the portfolio without having to dedicate internal resources. For many, this will help them sleep better at night. ■

<sup>1</sup> Casey Quirk & Associates LLC, "2010 Consultant Search Annual Survey," February 2010.

<sup>2</sup> Casey, Quirk & Associates, "The New Gatekeepers: Winning Business Models for Investments Outsourcing," December 2008.

<sup>3</sup> Cooper, Jay, "Billions in Play as Outsourcing Increases," FundFire, September 9, 2009.

<sup>4</sup> Ambachtsheer, Keith, "When it comes to pension plans, bigger is better," Counterpoint: The super-fund facts, posted April 29, 2009, <http://network.nationalpost.com/NP/blogs/fpcomment/archive/2009/04/29/counterpoint-the-super-fund-facts.aspx>

<sup>5</sup> Scheibelhut, Tom, "What makes a top performing fund?" Canadian Investment Review, Fall 1997.

<sup>6</sup> Louton, David and Hakan Saraoglu, "How Many Mutual Funds Are Needed to Form a Well-Diversified Asset Allocated Portfolio?" The Journal of Investing, Fall 2008.

<sup>7</sup> Goyal, Amit and Sunil Wahal, "The Selection and Termination of Investment Management Firms by Plan Sponsors," Abstract, Emory University, May 2005.