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A Timely Imperative

The need to manage increasingly complex investment portfolios in challenging markets by moving at opportune times underpins the rise in OCIO

The post-pandemic reality of higher market volatility and rising interest rates has highlighted the need for increased efficiency and effectiveness in institutional portfolio management and has accelerated the shift to the outsourced chief investment officer, or OCIO, solution. As asset owners take on more complex asset allocations, including private assets and alternatives, and more intensive risk management, they are turning to the OCIO model — the outsourcing of investment assets to a third-party manager who takes on day-to-day management and fiduciary oversight of the investment portfolio.

"The number of asset owners looking to outsource has definitely been picking up," said Dan Farley, global chief investment officer, investment solutions group at State Street Global Advisors. They continue to cite evergreen reasons for OCIO, such as the ability to bring in expertise that trustees lack in-house and to provide portfolio oversight and governance support, he noted. "But lately, efficiency and the speed of investment decision-making — whether it's an ability to make tactical calls in the marketplace or implement trades quickly — have been drivers of new mandates."

Since the COVID-19 pandemic shocked markets in March 2020, and especially with this year's accelerated interest rate hikes and economic growth concerns, the market environment has re-emphasized for many institutional investors that managing their portfolio requires constant and detailed attention, and that can be challenging for many.

Improved agility

"There's a need to be timely, to make sure you have the right investment strategy and to be nimble [to address] the things that don't work well on a quarterly committee meeting schedule. This has reinforced the importance of having the day-to-day management relationship that an OCIO can bring," Farley said.

Flexibility and agility in asset allocation has been critical in managing market volatility over the last two years. "There are short-term tactical opportunities that an OCIO can leverage, and that recognition has resonated with some asset owners who know they can't move as quickly, so they're open to considering other governance models that can be more responsive," said Heather Myers, nonprofit solutions leader at Aon.

In addition to opportunistic strategies that emerge, more asset owners are investing in nontraditional asset classes, especially alternatives and private markets, that require decision-making at appropriate times. "The ability to capture market opportunities quickly and efficiently has driven demand for OCIO as well," said Bryan Ward, head of U.S. solutions and sales at Aon.

Inflation and rising interest rates have ushered in a regime change in the investment environment, which has caused a knock-on effect across asset classes. Investors are having to think differently about portfolio construction and diversification. "A good example is pension plans that may be closing: [They] are facing volatile public markets and are looking more closely at private market solutions [in order to be better-positioned and meet return targets]. There's a need for more hands-on expertise in the more idiosyncratic asset classes, which an OCIO can bring to the table," said Tom Kennelly, head of OCIO investments at State Street Global Advisors.

Resource constraints

Another key driver toward OCIO, brought on by the pandemic and exacerbated this year, is resource constraints faced by asset owners. Institutions of all types, including corporate DB plans and nonprofits such as endowments, foundations and health-care systems, are typically engaging an OCIO provider due to a lack of internal resources and staff who can effectively manage the investment portfolio, said Lisa Schneider, CFA, managing director and head of client solutions at Russell Investments.

"Some don't have the internal expertise to evaluate the growing number of investment opportunities or to handle market challenges that get more complex by the day. For others, investment management is just not a part of their core business, and they have shifted focus away from managing a portfolio to focus on critical business needs. Both those reasons have been among the main drivers this year," she said.

"In the case of corporate plan sponsors, for example, rising interest rates have led to improvements in funded status. If you manage a closed or a frozen pension plan, you might prefer to have your finance staff focused on running the business rather than the pension plan," Schneider said.

The challenges of the post-pandemic markets have underscored the need for stronger governance processes. "The significant market volatility caused many asset owners' investment committees and boards to update their governance structures and evaluate their partnerships," said Jason Fisher, managing director and head of U.S. middle-market pensions at BlackRock, which has seen OCIO mandates pick up dramatically in 2022. "Even those who choose not to outsource investment management functions are looking for an extra set of hands at the wheel — to bring in a provider who has a holistic view [of the investment portfolio] as a supplement to their existing committee structure or consultant relationship," he said.

Mega impact

"Several megatrends are affecting defined contribution plans, and one thing has become clear: Plan sponsors are being pulled in too many directions," said Samantha Davidson, CFA, US OCIO leader at Mercer. Employers are experiencing dramatic change in the workplace, and their resources are strained as they handle the effects of inflation, supply-chain issues and a host of other global disruptions, she noted. In addition, "Consolidations through M&A and the Great Resignation have led to time poverty and a loss of institutional memory that often means having to reconstruct and back into approaches to problem solving, when not so long ago, solutions could be shared in an easy conversation, say, in a chance hallway meeting," she said, referencing the high numbers of employees who resigned and retired following the pandemic.

Endowments and foundations challenged by the current market environment are looking for increased expertise to meet long-term portfolio objectives and deliver a rate of return that exceeds inflation and their spend rates, said Schneider at Russell Investments. "Hospital systems are a specialized example. They're particularly challenged coming out of the pandemic. Plus, in the current economic environment, inflation affects health-care systems in unique ways, and they may not have the staff to manage those complexities within an investment program. Many are looking for partners that can help manage their assets in a way that supports their overall enterprise-wide financial plans," she said.

The Great Resignation has affected asset

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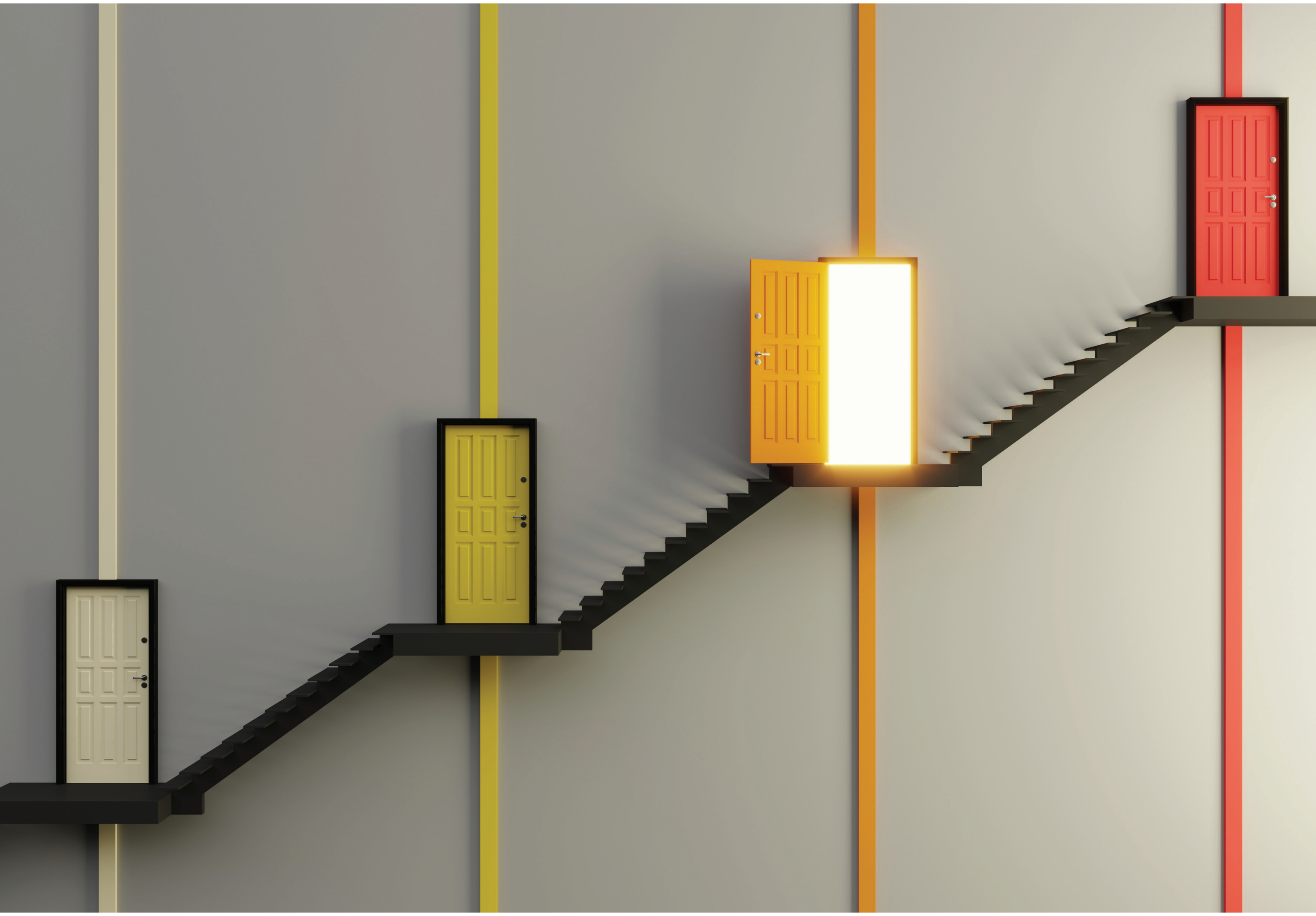
Taking a Dynamic Approach

OCIO providers are approaching asset allocation nimbly and using opportunistic and tactical moves to navigate through market challenges



The first half of 2022 brought the worst asset performance seen in decades, with the S&P 500 falling 21% and investment-grade bonds losing 11%, resulting in an uncharacteristic positive correlation between equities and bonds. That has led outsourced chief investment officer providers to be nimble and innovative as they help asset owners — from corporate pension funds and endowments and foundations to defined contribution plans — withstand the current market volatility and reposition portfolios to meet objectives.

"As we entered the year, the two major investment themes that asset owners were focused on were rising interest rates and inflation," said Martin Jaugietis, managing director and co-head of Americas pensions within multi-asset strategies and solutions at BlackRock. Regardless of investor type, they responded to rising interest rates both strategically, by having shorter benchmarks — even shorter than their liabilities if a corporate plan — and tactically, by underweighting duration relative to asset benchmarks, he said.

"In addition, some more nimble plans have been reallocating to assets that perform well in inflationary environments, like Treasury Inflation-Protected Securities and real assets. On the inflation theme, clients that tactically increased exposure to commodities and the energy sector would have benefited," he said.

Corporate plans, in particular, have benefited from the rising-rate environment and shorter-duration assets. "Even though investment returns are down, the rise in interest rates has caused liabilities to fall as well. Notwithstanding a volatile environment, corporate plans' funded ratios have held up reasonably well after having clocked large gains in 2021," Jaugietis said.

Allocation shifts

"Although defined benefit pensions weathered the first quarter of the year fairly well, largely because their liabilities have been devalued due to rising rates, higher nominal yields and pension discount rates, the current challenge is, Now what?" said Tom Kennelly, head of OCIO investments at State Street Global Advisors.

"There's been a lot of discussion around refining liability-driven investment portfolios, given the new shape of the yield curve," he said. While rates have risen across the board, they have risen more on the short end, flattening the yield curve. "When investors think about derisking, they're more focused on yield-curve exposure or key-rate duration exposure," he said.

This market environment necessitates being nimble to position a portfolio tactically, not just for return generation, but also for risk management. "It's important to overweight certain asset classes, particularly those that are more inflation-sensitive, so they can reduce risk and diversify. Given the market backdrop, we also see clients embrace rerisking, but the idea of looking at alternatives and private markets more holistically as an entry point could be good for those who have longer time horizons," Kennelly said.

"There's a misconception that a fully funded plan means you can set it and forget it, which is not the case. The management and strategy still need to be dynamic. The liability is a living, breathing thing, and as you pay benefits, the hedge needs to evolve as the profile changes over time," said Jaugietis. A handful of clients have explored pension risk transfer, where the role of the OCIO provider shifts to support those transactions with efficiency and low cost, he noted. "But often, there's still a legacy liability that needs to be invested against, which can be a different asset allocation from what existed before that transaction occurred," he said.

Many institutions have embraced private markets and alternatives, which have performed better than most listed asset classes over the last several quarters, but given the dynamics of how alternatives are valued, this has had implications for asset allocation. "As equities and fixed income dropped, many total-return investors saw increased exposure to alternatives in percentage terms due to the denominator effect. Corporate pensions, however, have sought to reduce their private market exposures given improvements in funded ratios — the average U.S. corporate plan is now close to 100% funded — and are seeking more liquidity," Jaugietis said.

"When markets begin to stabilize, we suspect corporate plans will seek more strategic long-duration exposure to preserve funded ratio gains and restore liability matching in their portfolios. It's an interesting crosscurrent relative to total-return investors, [who] largely are still maintaining shorter-duration positions with a view that interest rates may continue to rise," Jaugietis added.

Meeting current challenges

To manage through this complex market environment, asset owners are looking for an OCIO partner who has experience in understanding and managing through prior challenging times. "One of the most common evaluation questions we see on RFPs is whether we've managed through previous challenging economic cycles, such as 2008 to 2009, and how we navigated them. Many plans that had not already evaluated liability-driven investment strategies are looking for that now and, with funded status having improved, plans want to make sure they don't slide back if the market starts to move in the opposite direction," said Lisa Schneider, CFA, managing director and head of client solutions at Russell Investments. "We also see corporate plan sponsors that manage closed and frozen plans that are getting to fully funded status consider pension risk transfer strategies."

"Today, with the macroeconomic challenges we face and the markets we have seen, there's much more individuality in terms of investment solutions. What may be right for one DB plan or endowment is no longer right for another, and there are a lot of very interesting solutions available," said Heather Myers, nonprofit solutions leader at Aon. That's in contrast to the historical standardized models, where investment strategy was trifurcated based on the type of asset pool: DB was allocated one way, DC another and nonprofits followed the endowment model.

In today's markets, an OCIO has the unique ability to consider a variety of strategies, acknowledge each asset owner's particular circumstances and make thoughtful recommendations. "It's not one allocation, one implementation. For example, impact investing may be right for one sponsor; a hedge fund or private credit strategy may be right for another; and for some we might implement a more tactical, short-term allocation in response to portfolio needs and market conditions, depending on the asset owner's objectives, guidelines and other considerations," Myers said.

"The qualified ERISA pension market saw funding relief through ARPA and the Infrastructure Act," said Bryan Ward, head of U.S. solutions and sales at Aon, referencing the Employee Retirement Security Act of 1974 and last year's American Rescue Plan and Infrastructure Investment and Jobs acts. "Now

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that [pension funds'] time horizons have been significantly lengthened, there's been a trend towards diversifying into alternatives, as well as a focus on government- and investment-grade credit mandates," he said. Liability-hedging strategies and private markets come with a fair degree of complexity beyond the resources and capabilities that many asset owners have in-house. "This has driven increased demand for outsourcing some or all of those strategies," Ward noted.

In all market environments, "you have to focus on every single aspect of your program earning its keep, but it's especially true in a low-return environment," said Suzanne Bernard, not-for-profit OCIO practice lead at Northern Trust. With most major asset classes providing modest returns, asset owners must pay much closer attention to the active-passive mix, the total costs of management and manager selection. For instance, "for long-only strategies, you don't want to end up with a stable of active managers that combined create a closet index portfolio. Active managers that deliver customized solutions, in conjunction with indexing, are better positioned to take advantage of opportunities given their creative approach to investing," she said.

Tactical positioning is also key in a low-return environment. "It's important to have a clear view of where you are within your asset allocation range, and whether any variances are intentional and informed or where you have drifted. Being plus or minus 2 or 3 percentage points around a target has proven to be a consistent source of added value over time," Bernard said.

Embracing Alternatives

All types of asset owners have shifted more into alternatives and private markets than before. "Different types of investors have had different experiences through this market environment, which required them to consider the role that alternatives can play in a portfolio. We see a shift in the use of alternatives more broadly than simply as an engine of growth," said Dan Farley, global chief investment officer, investment solutions group at State Street Global Advisors. "Depending on an asset owner's endgame, it's important to be thoughtful about appropriate exposures. Is it private equity for growth or direct real estate for diversification? This market environment requires asset owners and OCIOs to carefully consider the role that alternatives play and how to build them into a portfolio," he said.

"There has been a strong focus on private investment strategies, and it's no longer just private equity," said Schneider at Russell Investments. There is much more differentiation, and the opportunity set has expanded across private credit, infrastructure and real estate. "It's no longer a collective bucket. We're now building asset allocation strategies that factor in expected risk and return profiles for the substrategies and their performance characteristics to ensure a diversified range in the portfolio that helps to meet a client's particular objectives," she said.

For instance, nonprofits such as large university endowments tend to look for higher rates of return. "Within private equity, they may focus more on venture strategies. They'll still hold a diversified private markets portfolio, but they may accept a slightly higher degree of risk to bolster overall return," Schneider said. "Investors with a lower risk tolerance might look for something more broadly diversified. That could include private credit, private infrastructure and perhaps opportunistic private real estate — those substrategies that perform differently in different economic environments," she said.

Manager selection can make a big difference. "We see a lot of asset owners investing in alternatives through major, well-known asset managers, [but] we've found that is not necessarily where you get your best alpha. Those private equity managers that are well known are not necessarily the answer going forward," said Bernard at Northern Trust. This underscores the need for OCIOs to have access and insights into a wide range of private markets and hedge fund managers, and to take a creative approach in working with them. "We believe the difference between a good OCIO and a great OCIO is one that takes the time to identify differentiated managers that provide exposure to innovative sectors of the alternatives universe and create customized solutions to deliver value," she said.

Streamlining DC

For DC plan participants, the biggest single threat to investment security, especially for near-retirees, is the drop in the large-cap U.S. equity segment and heighted volatility across public equity and fixed-income markets overall. "One major focus has been achieving that balance between improving asset allocation while streamlining investment options, and multi-asset strategies have been one viable avenue," said Samantha Davidson, CFA, US OCIO leader at Mercer.

"Plan sponsors have renewed their focus on increasing savings and contribution rates and optimizing asset allocation models to fit the [ways that] people really think about and use their money. Experience and research show that many participants have either too little or too much risk exposure, given their time horizon. They buy high and sell low. There's risk that comes from having too many menu options. Participants have been known to pick more than one target-date fund, for example, in the mistaken belief that it gives them more diversification," Davidson said.

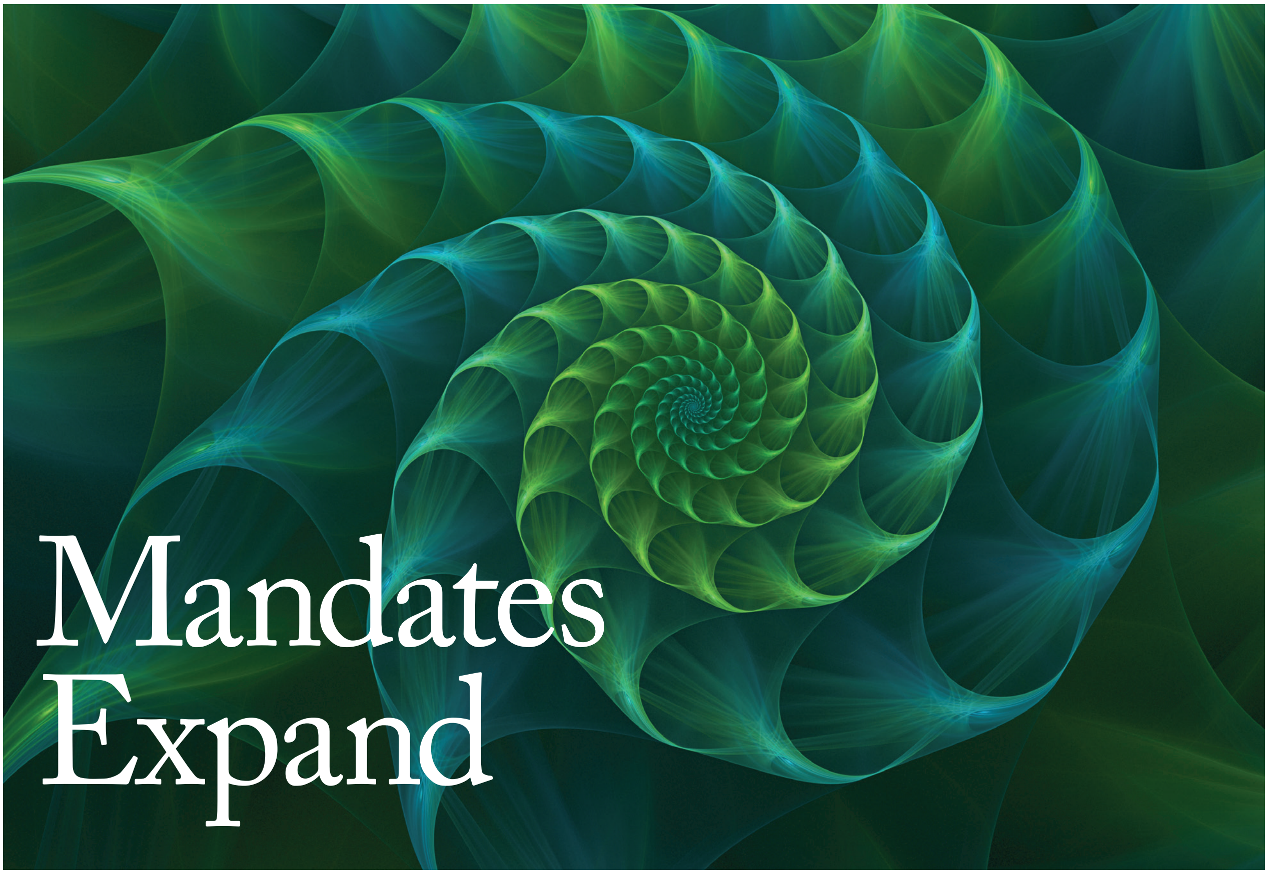
"A more participant-friendly approach to allocation, drawn from the experience of professionally managed pension plans, may be a good practice. Multi-asset strategies that combine managers with different exposures to risk factors could improve outcomes and lower investment costs for participants," she said.

"Furthermore, streamlining the investment menu is known to improve engagement, participation rates and contribution levels," said Davidson. Some plans might have 50 or more options. "We recommend about ten," she said.

Adding in-plan income options has been another key focus for DC plans. "We encourage sponsors to ask if their participants' future income needs are being addressed and managed. We also work with them to shift their mindset — as well as those of their plan participants — from asset value to risk-adjusted income," said Davidson. An OCIO provider with expertise in the 401(k) space can help plan sponsors address these questions and can also help identify and implement appropriate, personalized income strategies.

For example, many plan providers are looking to structure elements like income-embedded strategies and an auto-income qualified default investment alternative, or QDIA, into their menu design. Managed accounts are another area of interest for many plan sponsors, as the investment needs and financial lives of certain groups of employees become more complex in mid-to-late career, Davidson noted.

"For DC plans, the next phase of growth and innovation in OCIO will include improved participant data collection and analysis, which can significantly improve plan-design decisions," said Holly Verdeyen, U.S. defined contribution leader at Mercer. Many plan sponsors don't want to offer their employees an average plan, but customization can be at odds with the plan sponsor's ability to support it. An OCIO can help solve that. "This is all part of creating a more relatable organization, and it also supports the goal of retaining the assets of retired employees in the DC plan, which many plans are taking active steps to do," she said. •



Mandates Expand

Outsourced chief investment officer engagements are up in 2022 for all types of investment strategies across a menu of services — asset allocation, monitoring, governance and back-office functions — and demand is coming from all categories of institutional investors. OCIO assets worldwide, including full or partial discretion, increased to $2.66 trillion as of March 31, up 5.4% from 2021, according to *Pensions & Investments* data.

"The same types of investors are searching for OCIO, but there's been a major increase in overall numbers of investors this year, driven mainly by the increase in sophistication of asset strategy," said Bryan Ward, head of U.S. solutions and sales at Aon. "We also see more hybrid OCIO, which is outsourcing part of the portfolio. For example, the internal governance committee [may] keep the responsibility for managing public market investments but outsource the complexity of hedge funds and other alternatives," he said.

Asset owners have a lot of options today in modeling an OCIO relationship that meets their investment portfolio needs. "We can craft what [clients] need, and there are a lot of different ways to structure OCIO relationships. What one client needs and wants on a regular basis is quite different than what another needs and wants. Some require a high degree of interaction and others check in periodically, say, every quarter. It depends on the mandate," said Heather Myers, nonprofit solutions leader at Aon.

Myers said that she is also seeing more demand for operational and back-office support, not just investment management, which has become more critical with the growing use of alternatives. "Private investments are much more complex, with capital calls, distributions and pacing schedules that require more administration," she said.

Shift in clients

Historically, the growth of OCIO started in the small- and mid-sized part of the institutional market, initially with nonprofits, endowments, foundations and then corporate plans. Now OCIO has become pervasive across all asset-owner types and sizes.

"This year, we've seen tremendous growth in OCIO across client type and region. More asset owners have become more comfortable with OCIO, and the growth in our business has extended to family offices, insurance companies and health care. It continues to proliferate across channels," said Jason Fisher, managing director and head of U.S. middle-market pensions at BlackRock. "We've also seen the growth move upmarket. This year, we've seen a number of mega wins [of OCIO mandates] north of $10 billion. What they have in common is a high degree of customization. Each client has a different investment objective or problem set that they're trying to meet."

"Today, we see very large DB plan sponsors, even those above $5 billion, not wanting to maintain a staff to oversee a frozen or closed plan," said Lisa Schneider, CFA, managing director and head of client solutions at Russell Investments. Conversely, many foundations are seeking higher long-term returns from illiquid strategies. "These are the asset owners looking for an OCIO partnership that can identify the best private market solutions

More asset owners are taking on OCIO arrangements, from hybrid to full discretion, with market complexity driving the new business

and understand how to incorporate them into the total portfolio," she said.

OCIO reevaluations on existing arrangements have also increased. "Over the last two years, we've seen more RFPs from asset owners that are already in an OCIO structure looking for a change. It could be performance related, the level or type of service or a lack of overall fit," Schneider said. "A boutique firm that runs a single strategy may or may not fit the asset owner's investment committee expectations [for] how they [want to] execute asset allocation. When those things no longer align, asset owners may reevaluate what they're looking for. Similar to hiring an employee, overall fit is a key criteria," she said.

Asset owners' interest in OCIO stems from a wide range of reasons. "There's no single theme to the new mandates we see. Some have been fully delegated, mid-sized total portfolios, traditional in the OCIO space. At the same time, we see larger plans that are either looking to streamline or create a hybrid, partially outsourced solution," said Dan Farley, global chief investment officer, investment solutions group at State Street Global Advisors.

A common misconception among asset owners is that they'll have to adapt to their OCIO's model and won't be as involved in portfolio oversight. "That part of the governance model is often misunderstood," said Suzanne Bernard, not-for-profit OCIO practice lead at Northern Trust. "Asset owners looking to engage an OCIO, even in an advisory relationship, must make sure that they're clear about who's accountable for each piece and who's involved in the decision-making process for each piece. We work collaboratively with each of our clients to define clearly which responsibilities they will retain versus what we do for them."

Growth from DC plans

OCIO mandates will continue to accelerate in the defined contribution space, especially as DC plans grow by assets under management and complexity as they represent more of the overall retirement market while more DB plans close, freeze or terminate. "Plan sponsors need an experienced fiduciary to support prudent plan governance and ensure there's diversification, menu simplification and fee reductions, where possible. The OCIO also provides a second set of eyes to ensure [those responsible for] checks and balances are doing their jobs," said Lyndsay Ferencak, senior retirement OCIO specialist at Northern Trust.

"One reason DC is an area where we see increasing interest is to mitigate fiduciary risk in response to litigation around 401(k) sponsors' responsibilities," said Farley. Managing that risk — documenting that investment selection and managers are appropriate and comparable to others regarding fees and other considerations — can be burdensome. "Outsourcing it makes sense. We've seen the most interest from plan sponsors that still have a DB plan along with their DC plan," he said. Partial OCIO arrangements for DC plans are also trending, for example, acting as a fiduciary for a custom target-date fund instead of the entire plan. "We evaluate the overall plan and its demographics to identify a bespoke target-date structure, whether it's glidepath design, an asset class mix or manager selection," Farley said.

DC plan sponsors tend to outsource discretionary management on an asset class basis more frequently than in DB, said Ferencak. These are usually custom white-label solutions that offer diversifying strategies and reduce the decision fatigue that comes with a long lineup of investment menu options. Outsourcing also reduces the administrative burden for plan sponsors, because they can provide oversight of the underlying managers more efficiently," she said.

Some OCIOs provide the ability to bundle expertise and create synergies between DB and DC plans that allow some plan sponsors to outsource both, said Tom Kennelly, head of OCIO investments at State Street Global Advisors. "Bundling components of a DC plan with the DB plan has been popular. Outsourcing one piece leads to the evaluation of others to find synergies, efficiencies and consistency."

Technology and personalization

The expansive need for more robust technology and data security is also driving increased use of OCIO. "Making informed, outcome-driven decisions around a DC plan requires clear data on how those decisions will impact the plan's unique population, and there have been exciting developments in artificial intelligence and digitalization that allow sponsors to reboot their user experiences, making them more compelling," said Holly Verdeyen, U.S. defined contribution leader at Mercer. "DC OCIO providers really need to understand digital consumer finance trends," she said, especially those providers, like Mercer, who offer a pooled-employer plan, or PEP, "where the digital participant experience is vital, and service-delivery features — like do-it-yourself functionality, a consumer-friendly environment and mobile access — are outsourced as well."

"The key driver of OCIO in the DC space is efficiency and speed in managing the investment options in a lineup," said Ward at Aon. The plan sponsor still controls the options in the investment menu, and the OCIO selects the managers, whether for mutual funds, collective investment trusts, separate accounts [or] the rest. "If there's a new share class available that's cheaper, we can make a change right away. We don't have to wait for a committee to vote. Also, if our research team decides to downgrade and replace a manager, we can do it as soon as administratively possible. The speed of execution, especially in this environment, is very important," he said.

As sponsors look for ways to optimize their DC plans so that plan participants increase savings and improve their long-term financial well-being, they are recognizing the need for increased customization. Many are implementing strategies to deliver more personalized investment advice to participants alongside a more individualized user experience through their benefits portals. "Increasingly, this is done by an OCIO provider with the support of record keepers," said Verdeyen. "Plans of all sizes no longer want to be reliant on standard record-keeper reporting and communications. Overall, employee wellness is now a key priority for DC plans and needs to be considered a primary component of any modern plan's design," Verdeyen added.

"Of course, before any innovation can occur, participant data must be secure and protected. While recent Department of Labor cybersecurity program best-practice guidelines can be helpful in this regard, the task requires a great deal of coordination at the planning level," said Samantha Davidson, CFA, US OCIO leader at Mercer. •

Multi-angled Lens on Risk

Keeping a sharp eye on risk management across market scenarios is key, with an heightened focus on ESG issues

Asset owners have intensified their focus on risk management today, as they have increased concerns around liquidity, price variability and credit issues in current markets. Outsourced chief investment officer, or OCIO, providers have responded with improved tools and strategies to evaluate, monitor and mitigate risks. In addition, with strong investor interest in environmental, social and governance investing, particularly as it relates to climate change, OCIO platforms have embedded an ESG lens into overall risk management.

"There's a heightened focus on risk management whenever you're in a volatile market environment, but having a strong governance program [with your OCIO] ensures there's a heightened focus during all periods," said Lisa Schneider, CFA, managing director and head of client solutions at Russell Investments. "You can't let your guard down when equity markets are booming — or at any other time."

While retirement plans, qualified under the Employee Retirement Income Security Act, have long adopted OCIO arrangements for their strong governance and risk-management framework, those objectives are even more important today. "As plan sponsors look at their investment strategies and objectives, they realize it's harder to meet [governance] standards because of reduced internal resources and capabilities, increased market

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volatility and more complex and sophisticated investment vehicles," said Bryan Ward, head of U.S. solutions and sales at Aon.

An OCIO that provides a robust, multilayered risk-management system can help an asset owner understand a range of risks and evaluate the potential impact of each one. For example, different defined benefit clients are at different points along their glidepaths. "Credit risk becomes much more of a focus for a well-funded plan that's looking to annuitize. Inflation risk and equity risk are certainly top of mind for more return-focused investors. It's important to add a layer of governance for reporting and decision-making, and to provide oversight. You don't want anyone to be blindsided," said Tom Kennelly, head of OCIO investments at State Street Global Advisors.

As risk management evolves with every market crisis, it has led to better tools and an improved understanding of risk issues and risk tolerances, said Heather Myers, nonprofit solutions leader at Aon. "While you need to take risks in your portfolio to earn a return, they need to be appropriate risks that align with the asset owner's outlook, mission and total portfolio," she said, noting these can differ by hospital organization, endowment and foundation or corporate DB plan. "A good OCIO partner spends a lot of time thinking about appropriate risk management, and it's an ever-evolving process."

For instance, Myers said, "liquidity is always an issue, but the current dynamics of the equity and fixed-income markets are making us think differently about managing liquidity risk. We've stress tested portfolios for high inflationary and other volatile environments for a long time, and now we're doing it for climate change scenarios, which is increasingly important."

ESG integration

While many asset owners are pursuing ESG integration, the type of ESG approach and focus are very different by asset-owner type, Myers said. "We have a spectrum of clients: Some have evolved far in this space and others are still figuring it out and can't align around what they actually want. We spend a lot of time in discussions about appropriate objectives and targets," she said.

There's less uniformity around ESG objectives and approaches by U.S. asset owners versus those from other regions in the world. "The experience we have gained in working with many non-U.S. clients has enabled us to provide guidance to our U.S. clients that are just now looking at how to integrate ESG considerations into their portfolios. For example, U.K. plan sponsors are required to report on carbon exposure in their portfolios and how aligned their portfolios are with various climate change scenarios," said Schneider at Russell Investments, and the reporting developed for them provides a guideline for use with U.S. clients.

With ESG awareness and approaches varying among asset owners in the U.S., Europe and other regions, OCIO providers need to address client needs at different points in their ESG journey. "At the baseline, we work closely with asset owners to determine what ESG means to their organizations. Some just want to understand their risk exposures, others want to tilt their investment strategies explicitly to mitigate ESG risk factors, and others want to engage actively with companies to effect changes. An OCIO's role is to help tease out what's important to an organization and what it means for each one," said Dan Farley, global chief investment officer, investment solutions group at State Street Global Advisors.

Aligning values

Defined contribution plan sponsors are increasingly focused on ESG and, under the broader umbrella of corporate social responsibility, or CSR, aligning values has become an important part of investment menu design.

"Corporate social responsibility is one of the most visible ways that a corporation can align its values and mission with how its assets are invested to help deliver a more just and equitable future," said Samantha Davidson, CFA, US OCIO leader at Mercer. Although 92% of S&P 500 companies have published sustainability reports, only 37% have integrated sustainability themes into their DC plans, according to research from the Governance & Accountability Institute and Schroders. "We see increasing interest among plan sponsors in an OCIO approach as they focus on a number of sustainability issues, including ESG, sustainable investment policy adoption, vendor diversity and incorporating diversity, equity and inclusion into plan design. More and more employees are passionate about aligning their beliefs and values with their invested retirement assets," she said.

Diverse approaches

"There are many definitions of ESG, and having an awareness doesn't necessarily mean allocating an entire portfolio to those factors," said Martin Jaugietis, managing director and co-head of Americas pensions within multi-asset strategies and solutions at BlackRock. The firm has worked with some asset owners to develop performance reporting that evaluates their ESG exposures and then addresses those aspects in their investment strategy.

As ESG integration means different things to different investors, each one may address ESG risks differently. "We make sure the definition of ESG for each client is appropriate and supports how they position themselves. Awareness and integration start with education. [While] the endgame may be impact investing or directed investments that support specific ESG views, there are multiple points along the way, and it's our job to help them figure out which point is right for them," said Suzanne Bernard, not-for-profit OCIO practice lead at Northern Trust.

"We have clients across the asset-owner spectrum focused specifically on ESG factors. Some may prefer exclusionary screens like, for example, tobacco and fossil fuels, and we help them to define and understand the pros and cons. Others prefer to use investment managers that are more proactive in their positioning on key ESG issues," Bernard said.

Manager selection has shifted to include an ESG lens. "When we look at external investment managers, we look at their diversity practices and how they incorporate ESG factors in their analysis. Organizations that have a commitment to social responsibility and sustainable investing create greater value for stakeholders, and companies that don't pay attention to these issues have additional risk factors that investment managers need to take into account," she said.

"We have multiple means of implementation, but the process starts with evaluating and ranking the investment managers we hire in terms of their ability to understand and integrate ESG risk factors within their portfolios," said Schneider at Russell Investments. "It's not enough that a manager understands ESG — that's one subcategory [in their total evaluation] — it also must include success in integration and [all] those factors influence a manager's overall rank." •

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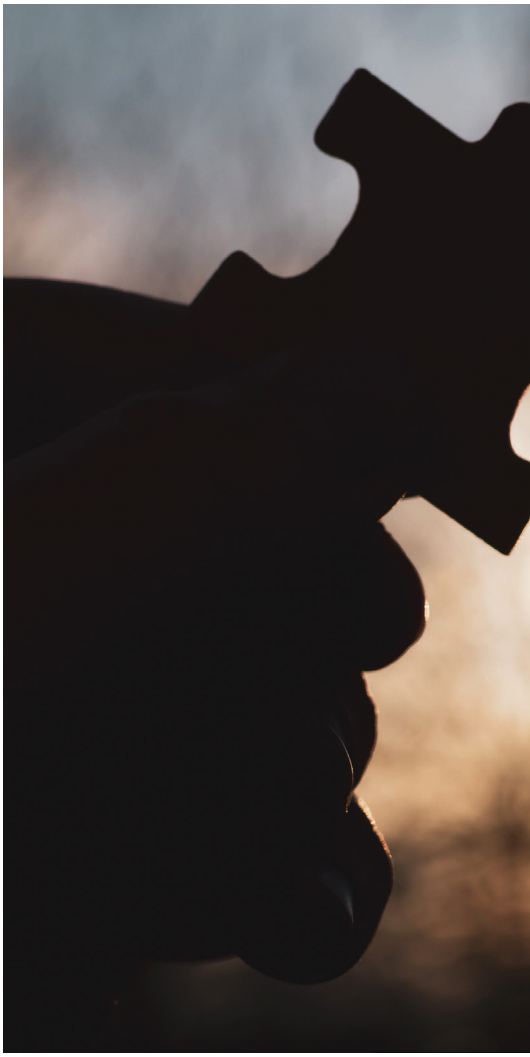
A Strong Handshake

Asset owners need to consider several factors when entering an OCIO partnership, starting with overall fit and alignment of objectives



Asset owners' confidence in the outsourced chief investment officer model is probably at an all-time high, driven by their need for portfolio management and governance in today's more complex market environment. As organizations spend more time trying to figure out how to operate their businesses under highly challenging circumstances, they are recognizing it is increasingly difficult to administer an asset pool and provide the close attention it requires. "More and more asset owners recognize how an OCIO solution helps" meet their investment objectives, said Lyndsay Ferencak, senior retirement OCIO specialist at Northern Trust.

"They are seeing the value of the OCIO partnership and leveraging it to their advantage through expanded capabilities and deeper expertise. Beyond simply meeting the organization's investment objectives, OCIOs are becoming true partners in their firm's culture and success," Ferencak said.

Layers of support

Some asset owners may have misconceptions over what an OCIO arrangement means in terms of giving up control of investment policy. "But, in fact, they're essentially getting an additional layer of governance and an additional set of resources. They're still heavily involved in setting investment policy, and the OCIO provider essentially provides oversight and implementation," said Jason Fisher, managing director and head of U.S. middle-market pensions at BlackRock.

"Investment committees often think that once they hire an OCIO, their role is diminished," said Lisa Schneider, CFA, managing director and head of client solutions at Russell Investments. "That could not be further from the truth." Both the OCIO provider and the investment committee should be fully engaged on an ongoing basis, she said. "This doesn't mean just participating in quarterly reviews, but active engagement in terms of ensuring there's alignment between what the client seeks and what the OCIO provider delivers."

"Defined contribution plan sponsors can choose how much to delegate to an OCIO, from advice to full outsourcing. Effective and frequent communication and complete transparency are absolutely critical, nonnegotiable items," said Samantha Davidson, CFA, US OCIO leader at Mercer. For example, an OCIO provider can step in to perform daily management tasks that the plan sponsor may not have the time or inclination to do themselves — while the sponsor still retains control over the strategic direction for the plan and even over certain investment decisions, she said. An OCIO provider can also help companies navigate changing regulatory regimes and, in certain M&A situations, help employers work through acquisition details. "Many sponsors find that by working with an OCIO, they finally have time and space to conceive and implement an integrated workforce strategy across all aspects of employee health, retirement and career planning," Davidson said.

The model client

Long-term portfolio objectives tend to remain very firmly with clients in nearly all OCIO arrangements, while day-to-day investment management, monitoring and manager selection can reside with the OCIO provider. "We're in the market every day, and we're looking at the portfolio every day. Should there be [market] extremes, we have the ability to be nimble and manage risk by leveraging proprietary technology. We don't have to wait for a quarterly board meeting to change out a position or a manager. This flexibility and engagement can lead to better outcomes, and asset owners can get better-integrated portfolio and risk management more efficiently," said Fisher.

OCIO providers are also aware of sensitivities around the role of asset owners' internal investment staff. "There's no doubt that hiring an OCIO can help manage their workloads, while clients still maintain an active staff — there's plenty of work required on the client side," pointed out Martin Jaugietis, managing director and co-head of Americas pensions within multi-asset strategies and solutions at BlackRock.

"We always begin by reiterating that the

most important strategic decision about the portfolio in terms of long-term asset allocation targets will always be owned by the client. They're making the biggest calls when it comes to their portfolio, and the investment policy statement establishes guidelines within the portfolio. The IPS is our guidebook, and we won't deviate from it," said Ferencak at Northern Trust.

"At the start of the relationship, it's critical to review and document the full decision-making process and all of the tasks throughout the fiduciary cycle to ensure all stakeholders — at the client and at the OCIO provider — are in full agreement over who owns each type of decision," said Schneider at Russell Investments. For example, if changes occur in the client's underlying business that might affect the investment portfolio, the OCIO needs to make sure it's informed and engaged as early as possible to manage any adjustments to the investment policy, return objectives or risk profile, she said.

The trusted partnership approach is key to the success of an OCIO arrangement. "Many of our clients lean on us as an extension of their staff. They recognize the benefit of our analytical tools and experience in the markets," said Fisher. "If we're managing the pension fund, we might be asked to look at the financial impact on the balance sheet and end-state planning. We might be asked to look more broadly at operating or liquidity pools, or perhaps a foundation that the organization sponsors. Many asset owners find merit to the partnership and leverage the manager's expertise and insights as an extension of their treasury, finance and investment groups."

Evolving remits

OCIO relationships evolve over time, and they can deliver different services for different clients. "For example, a decade ago, many of our [defined benefit] clients adopted a derisking glidepath with triggers based on funded status. When they met a trigger, they wanted to have the final say in reallocations," said Tom Kennelly, head of OCIO investments at State Street Global Advisors. "But now, because of more market volatility and time sensitivity, that discretion has been fully delegated to us."

Rebalancing can be another sensitive area. "Sometimes asset owners will revert to their strategic targets regularly, say each month or quarter, but others allow us to have the discretion, within ranges that are prescribed by their IPS, to express a market view or manage risk. That understanding is established in partnership with the client," Kennelly said.

"The key is to determine where the governance lies," he added. "We always make clear where we have discretion and where we don't, so there are no misunderstandings in terms of who owns what responsibility. The asset owner may own the final oversight of its OCIO provider, but the OCIO provider may own certain functions within the mandate."

Companies that want to offer leading, innovative plans and features often find they can do so in partnership with an OCIO. "Today's plan technology and governance demands are more complicated than 'fees, funds and fiduciary,'" said Davidson at Mercer, noting that the OCIO provider needs to work with the client's current technology platforms and plan administration as well. "Our DC OCIO approach is designed to address each client's unique technology and governance needs and to adapt as those needs evolve, from accessing global research and advice to full investment outsourcing, as well as governance and plan administration support," she said.

For the past three decades, managing a defined contribution plan was fairly straightforward, but that has changed. "Investment and regulatory complexity have ramped up, and fiduciaries are managing emerging issues such as digital assets, ESG and in-plan income options, while class action litigation and fiduciary insurance underwriting standards have placed a spotlight on fiduciary decisions," said Holly Verdeyen, U.S. defined contribution leader at Mercer. Often, DC plan sponsors are finding that it's easier to manage

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capacity, navigate complexity and drive customization through an OCIO approach.

Find the right fit

Asset owners should look at several key elements when evaluating an OCIO partnership. "It's important to think about the total OCIO offering. Asset owners looking only at returns should [look more broadly] in terms of strategy development, investment implementation, risk management and administration, and the best [OCIOs] are now delivering those aspects," said Schneider at Russell Investments. The investment committee's or board's expectations should align with those of the OCIO provider in delivering customized solutions and the OCIO's ability to add services that meet the client's unique needs, she added.

Can the OCIO actually deliver the objectives within the framework established by the asset owner? asked Bryan Ward, head of U.S. solutions and sales at Aon. While many firms handle traditional asset management, "when you get into more complex investment structures, such as alternatives, private markets and opportunistic strategies, the stable of potential OCIOs that can execute efficiently shrinks."

Asset owners are looking for OCIO partners "with the expertise to meet them where they are," said Kennelly at State Street. "While investment capability is a core criteria, and that is even more so given the current market volatility, the main focus has shifted to risk management," he said. Previously, the investment objectives for DB plans were performance-oriented, but now asset owners want to achieve other objectives, such as fully funded status, with possible hibernation and flexibility for lump-sum termination, buy-ins or buyouts, he said.

An OCIO's depth of staff with expertise in different client types is another key consideration. "We have staff dedicated to investor channels by client type — corporate plans, endowments and health-care organizations, for example. That specialized skill set allows us to focus on their specific needs, like long-term pools on a balance sheet or the insurance pools that cover the legal liability of a hospital, and in a coordinated way," said Jaugietis at BlackRock.

"Our staff has a wide breadth and depth of background within the industry. Many have held roles as plan sponsors and treasurers. Some have managed asset class portfolios, while others have been in administration and understand how the organizations are uniquely set up," said Ferencak at Northern Trust.

Operations and technology

An OCIO partner also needs to deliver a strong client-service experience and a robust operational platform, as administrative services have become more important today. "This includes transparent and flexible reporting for a variety of stakeholders, day-to-day support for ongoing questions from the staff and a range of administrative services that support back-office tasks. As asset owners' in-house staffs are stretched, OCIO providers can [add value] by picking up many of those functions," said Russell Investments' Schneider.

"We can't overstate the importance of technology," said Ward at Aon. In these volatile markets, the complexity of investments, metrics and risk-management requirements has risen dramatically. "You want an OCIO with a robust, technologically advanced infrastructure to oversee portfolios and manage trading, governance, compliance and reporting, and to have the resources behind them." While many firms say they can be an OCIO partner, some newer ones haven't made adequate investments in their infrastructure, he pointed out. "The more that your business grows and you go upmarket with $1 billion-plus mandates, investment complexity grows. It becomes all the more critical to have robust and seamless systems," he said.

Many asset owners also look for an OCIO's integrated approach to risk management. "We have a portfolio management system that contains each phase of our investment process. Asset allocation, portfolio construction, risk analysis and monitoring and performance measurement are all contained in a single ecosystem," said Jaugietis. "This provides real-time insight into client portfolios based on a single set of data. It also reduces operational risk. There are fewer sources of data, fewer handoffs — and we can see it through a single lens."

Cybersecurity risks can no longer be overlooked by OCIOs today. "It's extremely important to test how a data breach could affect the portfolio, assess the strength of a business continuity plan in the case of a cyberattack and provide continuous OCIO employee training," said Ferencak at Northern Trust. "Asset owners should look for OCIO partners that have healthy organizational budgets, broad and deep resources and robust technology infrastructure to protect client capital." •

A Timely Imperative

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owners in direct and indirect ways. "Organizations, especially in the private sector, are managing through the same things everyone else is — inflation, supply-chain issues and the rest — but they're reallocating resources to core business functions and away from managing pension plans. There are fewer people responsible for the asset pools, and they're being pulled in many different directions. For some asset owners, [their] formerly large investment teams are down to just a couple of people; in some smaller ones, it's now only a part-time job," said Ward at Aon.

"Asset owners are devoting more time and resources to running their businesses, often at the expense of investment oversight," said Suzanne Bernard, not-for-profit OCIO practice lead at Northern Trust. "Employee turnover and the resulting staffing shortages have made the problem worse, and this is happening across pensions, endowments and foundations. That underscores the need for the resources that an OCIO provides," she said.

The expertise gap

"It's much more challenging to find people to fill [internal investment management] roles, and this has had a big impact, particularly at institutions with small internal teams. The Great Resignation highlights the risks inherent in having a small group of people oversee assets," said Bernard. "We see much less knowledge transfer from retiring staff to newer employees, and they tend to lean more on their OCIO for portfolio construction expertise," said her colleague Matt Zumbach, senior client investment officer, corporate retirement at Northern Trust.

Succession issues have arisen across organizations. "Many long-term pension managers and CIOs are retiring, and it's becoming more challenging to fill those seats. At the same time, OCIO arrangements are increasingly cost-competitive [versus] having in-house investment teams; so OCIO continues to garner interest as organizations consider maintaining or lowering management costs," said Fisher at BlackRock. •

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