What just happened?

An insomniac's guide to OCIO

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I spent 20 years as a chief investment officer (CIO) at a large publicly traded California utility company. Some days were better than others, but I never had to guide my plan through a global pandemic.

Even in *normal* times, managing multiple large retirement plans was a challenging job. I had to have the answers to any questions around our defined benefit and defined contribution plans. I was helping to secure the retirement of my colleagues—and in many cases, the majority of their life savings. I was responsible for $20 billion in assets—including a $6 billion defined-contribution plan—and, by definition, keeping track of that many zeros comes with a few sleepless nights, even during calm markets.

What helped me sleep?

My team and I certainly did some things right. I felt confident that the defined contribution (DC) plan design we developed was on-point, which is good because it would be fair to say that the overwhelming majority of a corporate DC plan's successes or failures can be traced back to its deferral rates and match policy combined with age appropriate asset allocations. Strategic plan design is high impact, but it's low frequency. If you do it right, it doesn't change all that often.

What made me lie awake?

As CIO, my day-to-day charge on the defined benefit (DB) plan was to put the best money managers together and generate positive excess returns. I worked with a stream of top consultants to identify and hire the best managers. I combined these managers to control for risk and was confident that we would produce attractive active management results. It sounds simple. But, to be frank, it is really a lot harder than it sounds even when markets are calm. When major market events hit—like the dotcom bubble bursting in 2000 or the Global Financial Crisis of 2008—it proved to be downright terrifying.

The DC plan was tilted more toward passive management, mainly due to the committee's frustration with single active manager structures underperforming and the appeal of never having to explain below-benchmark performance. But that meant our DC participants were exposed to the full systematic risk of the market. I worried more during recessions and market declines, because I knew our DC options would track the market downward.

What just happened?

In a stock market crash, that systematic risk can be very significant. It carries one disappointing truth: it will cause some employees to postpone or cancel their retirement. During a crash, thinking about the difficult conversations that were no doubt happening in the homes of some of our near retirees weighed on me. Compounding the stress, many participants were not allocated properly for their age. We offered target date funds, also passively managed, but the majority of participants weren't using them, and their self-managed asset allocations indicated complacency when it came to rebalancing. When the crisis hit, no one expected our target date funds for those aged 60 and 65 to decline as much as they did; and some participants were panicking. Our recordkeeper's call center was swamped, and everyone feared participants would flee their long-term plans for safety, or cash-out their account balances entirely, only to miss out on the eventual rebound that would provide the opportunity for their account balances to recover. But I didn't understand how poorly equipped I was to meet that challenge until the hard questions came at the hardest possible times.

When volatility struck and the committee was asked about our employees' exposures—how they were allocated, how the plan options were performing and how participants were behaving—it was tough finding the right answers because my day-to-day view was limited. The review cycle occurred no more often than once a quarter—and even then, it wasn't a live view. It was decidedly backward-looking.

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Keep in mind that all this stress occurred in the face of substantial resources—a skilled internal team, outside consultants, custodians and others. I honestly thought I was taking a best-in-class approach. But if that was the case, why was I still lying awake at night worrying about the next market shift?

Until I moved to this side of the desk—and began working for one of the largest OCIO providers—I didn't realize that there was a pretty logical way of re-engineering this process. I finally recognized that the best outsourcing providers had already done the work.

OCIO provides visibility and bandwidth

A key need I had was to gain enough visibility to truly assess the impact the tumbling markets were having on participants' investments and trading activities. Employee communication and education became an urgent priority and understanding how employees were reacting amid the crisis was critical. I also needed to know exactly what risks were held in the plan investments and target date funds, how those risks aggregated and the impacts of those aggregations.

How does OCIO solve this? World-class OCIO providers serve as an extension of your team, fully coordinated with other plan vendors and proactive with the timely analysis and perspective demanded in times of uncertainty. These OCIO providers come with risk-management platforms. Ideally, the platform is security-based, updated daily and able to provide actionable information. Instead of the CIO or plan sponsor trying to mine for answers, the OCIO provider's portfolio management team provides clear visibility into the holdings of participant portfolios.

Russell Investments' OCIO team knows what each client owns at any given time. We can prepare a holistic report to share this information whenever needed. World-class OCIO providers can help establish the right messages for participants in the face of fear, to support good decisions and avoid poorly timed knee-jerk de-risking.

OCIO helps navigate the storm

In 2008, most plan sponsors and CIOs saw equities crater, causing asset allocations to move outside of allowed ranges. Plan sponsors with custom funds had to make difficult rebalancing decisions that were often subject to committee approval and debate. The problem is that investment committees are composed of human beings and this "let's-discuss-it" process can often cause fear to impede or delay a rebalancing decision that was designed in calmer times to ensure a specific risk budget was maintained. At a minimum, sponsors in 2008 needed to understand how their target date provider was dealing with the issue of rebalancing in capital markets that had gotten out of whack. Further, they needed to assess whether that approach was reasonable. Some DC plans were amid fund changes or target date fund re-enrollments, the costs and benefits of which needed to be weighed to ultimately decide whether to move ahead or postpone. And what was the best way to communicate those decisions to employees? When it came time for the plan investment review, making sense of how the investment managers fared during the crisis was also difficult. Performance results were disappointing across the board, but were they within expectations, given the market environment? Should the professional management and diversification of the target date funds have provided more cushion?

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So, how can an OCIO partner help alleviate these issues? For our OCIO clients, it would be rare not to execute according to the policy. But in choppy markets, our objective is to do so in the most cost-effective way possible. Minimizing transaction costs requires world-class trading capabilities, but also requires traders with decades of experience. As my colleague Jason Lenzo recently reminded us in his blog post, "The right stuff—how to find the right (outsourced) trading partner," traders who brag about having 10 years of experience have never traded in a bear market prior to 2020. It's vital for your OCIO partner to know through experience what it costs to move money in normal markets as well as what you are up against when moving money in stressed markets.

In addition to rebalancing, DC plans needed access to experts during this crisis to make implementation and timing decisions, and to respond to questions from employees. Adding to the strain, new legislation was enacted in the throes of the crisis with the CARES Act, and plan sponsors needed to quickly understand its impact and decide whether to adopt any or all of the provisions. DC plans also needed an expert to "compare notes" and use their experience with capital markets to help put this period into context. An OCIO partner brings a complete set of analytical tools to perform the quantitative work needed to assess results properly.

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In my former role, I'd advocated for a more sophisticated DC plan structure, on par with many other plans our size. I knew from our experience with active management that traditional active funds that hinged on single risk factor payoffs could have returns that varied widely from the benchmark. Unfortunately, for us, the construction of white-label multi-manager structures was too resource intensive from both an investment and communications/administration perspective. World-class OCIO providers have the capabilities to implement DC investment options with multi-manager portfolios, and can offer both custom and off-the-shelf options. They can support the operational, administrative and communications responsibilities that come with this approach.

A multi-manager investment option can provide a smooth ride with a diversified mix of active strategies blunting the extreme results any one strategy might deliver. A skilled OCIO provider will look to create an optimal risk-return trade-off by constructing a portfolio where risk is focused on security selection as opposed to large risk tilts. This approach avoids excessive volatility and smooths the ride for participants while also helping them to avoid behavioral traps.

And believe me, the value of a smoother ride of investment returns was easy to understand in the first quarter of 2020.

What are you doing now in response?

In late 2008, I was working to just get through the financial crisis. In 2009, my team and I intentionally took a breath and paused for reflection. We asked ourselves, "What could we have done better?" So, I challenge you, as an institutional investor, to take a breath and ask yourself: "What went right? What could have gone better? In what areas could I have used more specific expertise, harnessed more resources or both?"

For organizations that have the right level of resources, the right level of sophistication, the right level of vision and the strength of will, it may be possible to meet investment objectives with a predominantly in-house tool set. And we stand ready to assist those teams in any way we can.

But for others who see the potential of a more robust approach, **I staunchly believe OCIO is a solution worth exploring.** This isn't to say that OCIO is the right fit for everyone. But how will you know if you don't take the prudent step of going through an evaluation? Isn't it worth learning more about the potential, asking the hard questions and running the numbers? Wouldn't it be reassuring to your CFO and other leaders to know that you took that proactive step? If you can't conclude that the value proposition is real at the end of the process, at least due diligence has been done. This step alone may help eliminate a sleepless night or two.

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