RVK OCIO Insights

Issue 1: A Knowledgeable Way to Evaluate an OCIO Provider

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RVK's OCIO Evaluation and Monitoring Practice

Overview

RVK's Outsourced Chief Investment Officer (OCIO) Evaluation and Monitoring Team (RVK OCIO E&M Team) has been conducting OCIO education, search, evaluation, and monitoring projects for over seven years. Throughout this time, we have advised asset owners on how to navigate the particular challenges associated with evaluating OCIO providers. In RVK's first edition of OCIO Insights, we highlight elements often overlooked by asset owners when evaluating an OCIO provider—Board/Investment Committee governance structure, key components in understanding a track record, and due diligence on business aspects of an OCIO. This publication will review the importance of these elements in accurately assessing an OCIO provider's fit with the asset owner's investment goals, governance, decision-making process and monitoring program.

Board/Investment Committee Governance Structure Matters

Based on our experience working with fiduciaries, we have observed the importance of alignment between an asset owner's governance model and the OCIO provider's service model in fostering a successful engagement, and how often that alignment is assumed to exist. The concept of governance/service model "alignment" includes many aspects of an asset owner/OCIO provider relationship: meeting attendance, communication of key investment actions and their drivers, transparency in affirming compliance with investment policy and risk limitations, as well as key organizational changes, content of investment reports, and, perhaps most importantly, a clear agreement regarding which party has ultimate decision-making authority over various portfolio management decisions.

A common breakdown in the alignment between asset owners and OCIO providers is decision-making authority, particularly for governance structures transitioning from Board/Investment Committee-led decisions to OCIO-led decisions. We believe that fiduciaries take the necessary time to deliberate over this transfer of investment decision-making authority and do so with the goal of ameliorating the quality, speed, and outcomes of investment decisions. However, fiduciaries' thoughtful consideration and intentions may be missed in either the documents that govern the assets, or by the actions of new Board/Investment Committee members. That missed step can introduce ambiguity over which party has the authority to make specific investment decisions.

When the RVK OCIO E&M Team engages with a client, we begin by reviewing the existing governance structure with fiduciaries in order to confirm the current state of policies, as well as understand how the fiduciaries operate in practice. In some cases, we have discovered that policy and practice diverge, often driven by good intentions. Once the review is completed, the discussion shifts to the client's prospective preferences for goals, objectives, and management decisions for the portfolio. We have observed three aspects of governance that most commonly lead to a breakdown of alignment between the asset owner and OCIO provider:

1. Investment philosophy,
2. Veto authority, and
3. Episodic board intervention.

Investment Philosophy

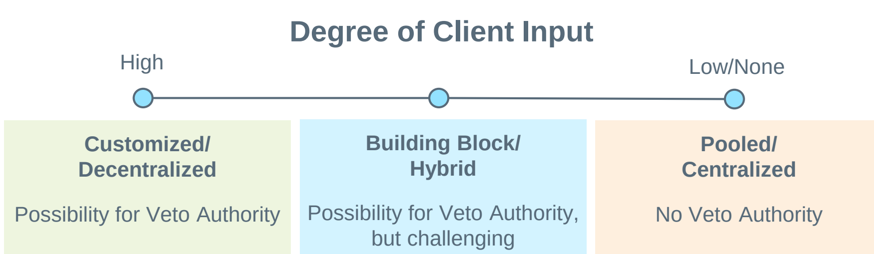
In order for members of a fiduciary body to successfully manage the institution's investment portfolio, they must maintain a consistent investment philosophy. Over time, and as members of the fiduciary body change, the consensus and investment philosophy may shift and even the manner in which the institution invests its assets can evolve away from the established and documented investment philosophy—often in directions not anticipated prior to the change in Board or Committee membership. Such a change can create challenges when evaluating and measuring the success of an incumbent OCIO provider that continues to manage assets according to objectives and expectations set by a prior group of fiduciaries.

When evaluating an incumbent OCIO or conducting a search for an OCIO provider, actual or potential changes in the fiduciary body's philosophy may also affect the type of OCIO that is appropriate to manage the institution's assets. Regardless of the type of project (evaluation or search), an OCIO's evaluation should be based upon an investment philosophy supported by a consensus reached by the fiduciaries. Investment philosophy alignment significantly increases the likelihood that the selected outsourced solution will closely align with the mission, goals, and objectives of the institution.

In order to increase the likelihood of a successful evaluation or search process, we collaborate with the fiduciary body to affirm (or reestablish as necessary) and document a cohesive investment philosophy. During this initial discovery process with the client, we review items such as the Board/Investment Committee's preference for active strategies versus passive strategies, the fund's liquidity needs and preferences, and the tolerance for "looking different" when compared to organizations the Board/Investment Committee views as peers. After confirming the institution's investment philosophy, we document it for our evaluation/search and for the Board/Investment Committee to share with the OCIO when revising the portfolio's investment policy to ensure all parties are "on the same page."

Veto Authority

Asset owner/OCIO relationships encompass a wide spectrum of decision-making delegation. On one side of the spectrum are relationships where the asset owner delegates all aspects of the investment program except for the investment policy (excluding commingled total funds). On the opposite side of the spectrum are relationships where the asset owner delegates elements of the investment policy, but maintains the ability to reject specific investments. Many relationships also exist somewhere in between these two poles. RVK refers to the ability of a Board/Investment Committee to reject an investment as *Veto Authority*.



We believe that Boards/Investment Committees should discuss their preference for maintaining veto authority and understand the implications of including it in an OCIO relationship. The existence of veto authority within an OCIO relationship can affect ownership of a client's performance track record, the speed of decision making, and operational considerations, like legal contracting. OCIO firms that implement the investment portfolio through commingled "best ideas" funds are likely not a good fit for a client who wishes to maintain veto authority. There are also several OCIO firms that implement custom portfolios via direct managers that are not willing to include veto authority in their portfolio management process.

Episodic Board Intervention

Asset owners who engage an OCIO remain fiduciaries with the ultimate authority and responsibility for investment portfolios despite the delegation. OCIO providers may be tempted, like any other vendor, to tell a client what they believe the client wishes to hear, and say they can do what they believe the client would like them to do. In our view, clear governance and clear delegation of investment decision-making authority and responsibility can mitigate such natural human instincts. However, vague governance and delegation can be fertile ground for telling/doing what the client seems to want, leading to no clear accountability for investment outcomes.

The potential implications of episodic board intervention can be seen through the following example:

A Board decides that a unique event (such as the recent COVID-19 pandemic) has temporarily changed its risk tolerance and instructs its OCIO to raise cash outside of policy ranges without making a formal amendment to the investment policy. Even though the action would violate the stated policy range, its OCIO might follow the request to preserve its relationship with the Board. Once cash is raised, the portfolio maintains an out-of-policy allocation to cash until the next regularly scheduled Board meeting three months later. During the time between meetings, risk assets outperformed and the outsized cash position in the portfolio detracted from relative performance.

This scenario prompts the question: Who is responsible for the relative underperformance? From the Board/Investment Committee's standpoint, the performance of the portfolio is the responsibility of the OCIO. In response, the OCIO would likely assert that it acted as instructed by the ultimate fiduciary. While each side has a reasonable argument, the conflict would have been avoided entirely with clear communication and documented accountability.

Clients benefit from documenting any protocols guiding Board/Investment Committee policy intervention to mitigate potentially making a harmful decision without proper deliberation. The primary issue in the aforementioned example is not the Board's intervention, but rather the lack of process to guide the OCIO or the Board on next actionable steps. To mitigate this issue, a Board/Investment Committee might consider developing policy protocols for potentially directing its OCIO to take specific actions in case of extraordinary circumstances.

Track Records Matter, but they are not the Primary Decision Point

When searching for a particular investment product, whether a small cap equity mutual fund or a middle market buyout fund, one of the first items up for scrutiny by a potential investor is the proof statement that the fund has been successful—its track record. That track record, measured against a benchmark, often determines if an investor will conduct additional research on the fund itself. While there may be a tendency to focus on results, we believe appropriately evaluating a track record is rooted in understanding the investment basics of who, how, and what led to that historical track record.

A great historical track record is only the "tip of the iceberg" that floats above the massive block of information that explains the reason for those numbers. As a search consultant, it is our job to immerse ourselves in the details of an OCIO's team and ascription of responsibilities, investment philosophy and process, structural and dynamic tilts of each asset class composite, and performance attribution. Together, all of these factors help to explain the OCIO provider's track record. While we believe a track record is important, it is the final factor in our evaluation because the building blocks of sound due diligence lead to understanding the track record.

The "Who" of the Track Record

The OCIO business largely remains a boutique business model. We would argue that even large, multi-line financial firms run their OCIO operations like a boutique firm because they concentrate final decisions with a small number of key investment professionals. Whether an OCIO provider has a sole CIO or an Investment Committee structure, it is important to understand the process by which an idea becomes a funded investment. It is critical for our team, and for our clients, to know precisely who is (or was) responsible for the investment decisions that built a firm's track record. As such, it is important to spend ample time with the researchers, asset class leaders, and lead CIOs who map out decisions from inception to implementation, which we use to assess the impact of various decision makers, as well as the potential effect future personnel turnover may have on future performance.

The "How" of the Track Record

It is easy to judge whether an OCIO has been successful if its total fund track record is above a generally accepted and easily calculated benchmark (e.g. 60% S&P 500/40% Bloomberg Aggregate benchmark). However, we would argue that this comparison may not convey much useful information. Simply constructed benchmarks may not fully capture the amount of volatility or exposure to potential downside risk embedded in the OCIO's portfolio. Conversely, it is easy to dismiss an OCIO that underperforms that same benchmark without understanding the reasons for the shortfall. When conducting due diligence, it is critical to delve into an OCIO team's method for constructing both its asset class composites (e.g., allocations to passive vs active and the use (or lack) of alternatives) as well as their stance on making tactical tilts within an asset class or at the total fund level.

Without understanding how and why OCIOs build their portfolios, a Board/Investment Committee might be challenged to understand which market conditions might be reasonably expected to yield outperformance and underperformance relative to a generic benchmark. Analysis of an OCIO's performance requires a deep understanding of, and experience in, asset class composition, mandate creation, and manager performance. Understanding each OCIO's investment philosophy, and the details by which it is implemented, allows our OCIO E&M Team to narrow the broad list of OCIO providers in the marketplace for clients to consider. A more focused list of providers allows us to match the risk tolerance, unique investment objectives and general circumstances of our clients with similarly minded OCIO providers. Over the many years and projects our team has conducted, we have witnessed that there is no one-size-fits-all in the OCIO industry.

The "What" of the Track Record

Over the last couple of years, there has been an increasing demand by clients for validated track records according to generally accepted investment industry standards—specifically the Global Investment Professional Standards (GIPS)[1].

[1] Global Investment Professional Standards (GIPS) were created by CFA Institute (formerly the Association for Investment Management and Research). They are a voluntary set of standards that were developed on the principles of full disclosure and fair representation of performance results. GIPS are a globally accepted industry standard for the calculation and presentation of historical investment performance for asset managers. (https://www.gipsstandards.org/standards/2020/Pages/index.aspx) While GIPS has been widely accepted among asset managers, it has only recently begun to be considered and implemented for the OCIO's track record.

A small but gradually growing number of OCIOs have either completed or have begun the process of becoming GIPS compliant and verified. Compliance with GIPS standards has been the gold standard within the asset management industry for years, and consultants typically conduct searches only for investment products that comply with GIPS standards. The pool of investors in these GIPS-compliant products is often large with a homogenous investment philosophy dictated by the asset manager. Conversely, the clients of OCIO providers may often have similar end goals, such as meeting similar spending rate goals or fully funding pension plans, each of an OCIO's clients may have significant differences in their approved target allocation, acceptable investments, and investment horizon. These discrepancies can challenge one's ability to compare OCIO providers' total fund composites without a great deal of analysis and scrutiny.

We believe that when a Board/Committee analyzes a GIPS-compliant track record, there should be a focus on answering several questions regarding the size and homogeneity of the data, including:

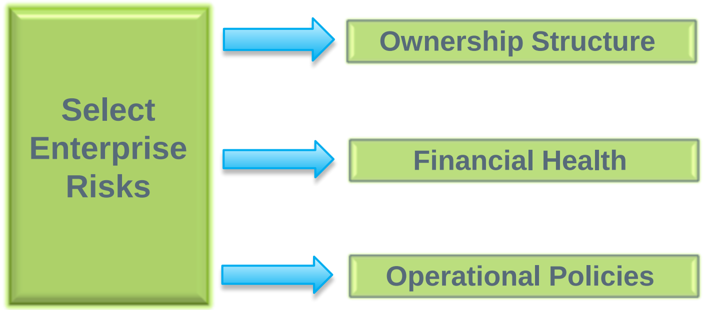
- What percentage of clients are included in the composite?
- What clients are excluded and why?
- What is the dispersion of returns?
- How similarly-invested are the return-seeking assets and non-equity assets?
- How reflective are GIPS composite portfolios of a prospect's proposed portfolio solutions?

We have observed OCIOs creating composites with specific criteria. This increases the number of an OCIO's GIPS-compliant composites, but lowers the number of underlying portfolios in each composite. Thus, there is the potential for OCIOs to cherry pick the composite track record they present to prospective clients, which may not be a complete representation of their broader clients' actual experience/track record. As such, we apply both a qualitative and quantitative approach to our expert analysis of OCIO providers' track records. We take this approach because we firmly believe that the importance of a track record comes from a series of analyses of the components that created that record, not just the valuation of the track record alone.

Due Diligence Beyond Investments/Portfolio Management

One of the primary reasons Boards/Committees implement an OCIO model is the expectation that it will improve performance. Given that objective, many investors tend to focus their due diligence on evaluating an OCIO's resources and processes directly related to investment portfolio management and performance, such as key investment personnel, portfolio construction processes, asset allocation structuring, manager selection processes, and performance metrics. However, OCIO providers are businesses and thus present clients with enterprise risk as well as investment risk. Conducting due diligence on the business aspects of an OCIO provider and understanding the potential risks associated with various elements of an OCIO's organizational structure is equally as important as investment management and performance. Without a stable and sustainable business model, the success and longevity of an OCIO provider is questionable.

Part of RVK's comprehensive evaluation of an OCIO includes an analysis of the enterprise risks of the firm. Below we highlight a few business components an asset owner should examine when evaluating an OCIO provider.



Ownership Structure

There is no optimal ownership structure associated with the success of an OCIO provider. Ownership structures vary significantly and range from 100% employee owned to a wholly owned line of business within a publicly traded entity and may be a combination of employee and outside ownership. Each type of ownership has its potential benefits and shortcomings, and we have observed varying levels of success among the different types of business models. However, not every model fits the preferences of every client. Therefore, when evaluating an OCIO's ownership, we review the details of the ownership structure and its implications for future success and continuity given the OCIO's unique circumstances, as well as how the firm addresses potential risks associated with the ownership structure.

For example, a 100% employee ownership model generally provides a more direct alignment of interest between employees' careers and compensation and the growth of the business. This model gives the owners autonomy over the direction of their company. In addition, equity ownership can be a powerful tool to attract and retain talented investment professionals. However, when a few owners or even one individual represents a majority of the equity, a single departure can challenge the future of the firm. When we observe ownership concentration, we ask a specific set of questions to understand the OCIO's ability to manage a transition with little to no disruption in the management of our clients' assets. Such questions center on: future ownership distribution, transition of responsibilities, and focus of firm growth under new leadership.

Conversely, an OCIO group that is part of a multi-business line financial firm can benefit from the extensive resources and dedicated teams available through the broader firm, including market and manager research, operations and back office, substantial experience in discretionary management of assets, compliance, and marketing. More specifically, a firm's global reach and ancillary services provided by various business lines, can be advantaged for the OCIO group. However, this type of ownership structure, if poorly executed, can result in muting the authority of key OCIO decision makers to set the direction and growth of their business unit. In addition, the OCIO business unit also shares in any risks associated with the parent company. Furthermore, the values, goals, and objectives of the parent company can differ from those of the OCIO business. Finally, changes in strategic directions or other internal disruptions within the parent company can adversely affect the ability of the OCIO business to execute for clients.

When RVK's OCIO E&M Team evaluates an OCIO that is a subsidiary or a group within a larger financial entity, we assess the parent company's growth plans for the OCIO business (e.g. revenue expectations, compensation schemes, cross selling opportunities, marketing plans, etc.). We also review the stability of the parent organization and examine the OCIO team's degree of dependence and reliance on the parent company's resources. Lastly, it is critical to reevaluate ownership structure on an ongoing basis, especially when there is a significant change in the firm's leadership, product, business strategy, and/or service offerings. These changes can alter the importance and role of an OCIO business within the parent company and create risks for clients.

Financial Health

An important component to the success and longevity of any business is financial stability. It may be an obvious statement, but tenure in the market is not a dependable measure of forward viability. Evaluating the financial health of an OCIO can be quite challenging given that audited financial information may not be disclosed nor publicly available. For OCIO teams housed within a larger financial firm, it is often unrealistic to obtain financial information solely attributed to the OCIO line of business. However, investors can gauge financial stability of an OCIO by evaluating certain revenue and expense related information OCIOs are able to provide and by having discussions with key decision makers regarding the metrics used to measure profitability.

A client should also evaluate an OCIO firm's strategy for managing unexpected events that can significantly impact its revenue, such as the inability to meet near-term growth expectations and significant client turnover/client AUM withdrawals. Although insightful, obtaining details regarding a firm's expenses (such as employee salaries and benefits, rent, equipment cost, etc.) can be challenging. To evaluate this aspect of an OCIO, it is important to discuss the firm's process for evaluating firm expenses, responsible parties for approving these expenses and setting the budget, and the frequency of reviewing expenses.

Operational Policies

Evaluating the operational policies and procedures of any investment firm is as important as evaluating its investment process. This exercise becomes even more critical when hiring an OCIO, given the fiduciary responsibilities and decision-making authority an OCIO retains over a client's portfolio. Policies and procedures that are clearly stated, tested, and strictly monitored can build confidence in an OCIO's accountability for managing a client's pool of assets. A review of an OCIO's operating policies, often incorporated in the firm's compliance manual, should include conflicts of interest, insider trading, valuation, cybersecurity, and data privacy. RVK's OCIO E&M Team also reviews the firm's disaster recovery plan, which outlines process and procedures for data recovery, protections around IT infrastructure, and business continuity frameworks in the event of a disaster. In addition to ensuring an OCIO has best practice policies, it is important to understand the individuals or teams responsible for reviewing and updating these policies, how these policies are monitored for compliance, and how frequently the policies are reviewed, updated, and tested.

About RVK's OCIO Evaluation and Monitoring Practice

RVK, Inc. ("RVK") has been providing OCIO search, evaluation, and monitoring services to institutional clients since 2012 and has conducted over 50 projects. Our OCIO Evaluation and Monitoring practice was a natural extension of RVK's sole line of business of providing non-discretionary investment consulting services to institutional clients since 1985. The success of our group has led our firm to add a companion practice—RVK Investment Program Review—focused on reviewing a Board's or Investment Committee's governance, structure, operations, and the efficacy of their own internal investment organization.

Contact us to learn more about how we can educate and guide you through the important and long-term decision of evaluating the OCIO option, hiring an OCIO, as well as to discuss how we can help fulfill your fiduciary duty to monitor and evaluate an incumbent provider.

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RVK was founded in 1985 to focus exclusively on investment consulting and today employs over 100 professionals. The firm is headquartered in Portland, Oregon, with regional offices in Boise, Chicago, and New York City. RVK is one of the ten largest consulting firms in the US, as reported by *Pensions & Investments' 2019 Special Report – Consultants*. Additionally, RVK received a notable award in April 2020 when it was named a Greenwich *Quality Leader* among large US investment consultants, based upon Greenwich Associates' 2019 study. Greenwich is an industry-recognized third-party firm which asks plan sponsors to rank their consultants on a series of key metrics. Notably, RVK is the only firm among large US consultants to receive an award for a third consecutive year.[1] RVK's diversified client base of over 190 clients covers 30 states, and covers endowments, foundations, corporate and public defined benefit and contribution plans, Taft-Hartley plans, and high-net-worth individuals and families. The firm is independent, employee-owned, and derives 100% of its revenues from investment consulting services.

[1]Between July and October 2019, Greenwich Associates conducted interviews with 1,100 individuals at 896 of the largest tax-exempt funds in the US–including corporate and union funds, public funds, endowments and foundations–with either pension or investment pool assets greater than $150 million. Study participants were asked to provide quantitative and qualitative evaluations of their asset managers and investment consultants, including qualitative assessments of those firms soliciting their business and detailed information on important market trends. RVK is one of three firms recognized in the large investment consultant category. The ratings may not be representative of any one client's experience with RVK; rather they are representative of those clients submitted and that chose to participate in the survey. The results are not indicative of RVK's future performance.

To read the Greenwich article, please refer to the following URL: https://www.greenwich.com/sites/default/files/files/reports/Five-Factors-Distinguish-Best-in-Class-Consultants-Average-Practitioners.20-4012.pdf

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