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AN ANCHOR IN CHALLENGING MARKETS

OCIO proved its mettle during the turmoil of the pandemic and sees demand for customized and flexible outsourcing.

The OCIO world is continuing to expand as more asset owners seek to shift away from internal investment management to outsourced solutions that can best fit their portfolio needs. The outsourced chief investment officer model demonstrated strong performance through the highly challenging market environment in the early months of the COVID-19 pandemic and into the rest of the year. That has boosted demand for investment management services — both full discretionary services and partial advisory or discretionary services — from asset owners of all sizes, who are also drawn to the increasingly flexible OCIO solution sets offered by third-party providers.

Strong market performance and growth in OCIO strategies, both partial and full discretion, led to a rise in total OCIO assets worldwide to $2.46 trillion in the first quarter of this year, a 22.7% gain over last year, according to *Pensions & Investments*' industry data.

The traditional elements of an OCIO arrangement continue to be strong selling points today: more efficiency in the investment management process, better governance, improved risk management and improved risk-adjusted performance, along with reduced administrative burdens for the asset owner. "Beyond meeting client investment objectives, the real goal of OCIO is to keep the investment management process frictionless and seamless for clients while providing full transparency," said Kate El-Hillow, global chief investment officer at Russell Investments. "It's getting harder for asset owners to navigate markets on their own, and that's making an outsourced model more attractive."

Organizations adopt an OCIO model because they want to get better investment outcomes, reduce risk and save time, resources and potentially even fees, said Matt McDaniel, partner and U.S. financial strategy group leader at Mercer. Organizations "that had moved to an OCIO-type solution before the pandemic benefited from the ability to have somebody whose full-time job [involved] monitoring and executing the strategy that they set. Those that hadn't moved yet to an OCIO model felt that strain [during the pandemic] and saw there were opportunities in the market that they weren't able to access" that an OCIO manager would have been able to act on, he said.

An OCIO relationship can anchor the oversight process of the investment portfolio through potential leadership changes at an organization. "The OCIO model brings consistency and sustainability," said Thomas Kennelly, senior investment strategist for OCIO at State Street Global Advisors. "When I look back in time, some clients have experienced a lot of turnover in their committee. It is very useful to have the institutional knowledge and stewardship of the portfolio [and the ability] to educate new members."

FLEXIBILITY AND TRANSPARENCY

As the OCIO model has evolved, it has grown into an array of solutions ranging from partial outsourcing of specific portfolio assets to fully delegated discretionary investment management. "Everyone's needs are different and [their] resources and experience are different," said Chris McGoldrick, managing director, OCIO Solutions at PNC Institutional Asset Management®. An OCIO arrangement needs to be flexible enough to accommodate a client's portfolio management needs at a particular point and then evolve as those needs change over time, he added.

While the pandemic had accelerated client interest in fully delegated OCIO solutions, "that's certainly not the only governance model that organizations are using," McGoldrick said. What all of these OCIO choices have

in common is an emphasis on transparency. "All clients want more of a sense of what's going on behind the scenes, and they are less satisfied with the black-box mentality that could be found historically with some OCIO providers," he said.

The type of OCIO solution that an asset owner selects depends on their immediate needs, timing and market situation. In a semi-delegated model, the OCIO manager or consultant may have discretion around elements of the program such as rebalancing, taking a tactical view, derisking or hiring and firing managers, said Kennelly. "This type of shared model can work well in certain cases," he said. "But in some cases, it may not work as well when" decisions need to be made quickly.

While the key elements that make up an OCIO solution are familiar — good governance, investment oversight, and operations and implementation — "the risk-management component really needs to permeate all three of these areas," said Jennifer Kruse, partner, U.S. investment solutions and client management leader at Mercer. The OCIO provider needs to provide the solutions that will allow the client to prioritize the time they commit to managing their assets. For instance, if a committee finds it challenging to handle operational issues, the OCIO can step in to provide support, while other organizations may need a more holistic solution via full outsourcing.

OCIO has evolved in the past three to five years to offer a more wide-ranging level of customization. Clients no longer have to choose between pure advisory or fully delegated discretionary solutions. "We're seeing an increasing number of clients looking to outsource one or more asset classes while retaining [the in-house management of] others," said Kevin Zagortz, U.S. head of portfolio management at Aon. "Some clients want to retain manager selection but outsource rebalancing and implementation. This is most prevalent in defined benefit plans with glidepaths to hibernation, who simply want an OCIO to provide nimble implementation of an agreed-upon strategy."

UNDERSTAND THE VALUE-ADD

Russell Investments' El-Hillow identified three main pillars in an outsourcing relationship between client and OCIO: advice, service and investment management. "What we now see is an expansion around how people are using those tools," she said. "In the past, we might have seen more straightforward requests: 'Help me with an asset allocation' or 'Select some managers for me.' Now clients want help with thinking through the trade-offs that come with implementing ESG factors or increasing allocations to private assets." As in-house staff are more resource-constrained today, it can be difficult to manage these more complex asset allocation considerations themselves, she noted.

The key question for OCIO arrangements is to define what the model provides that clients can't get elsewhere. "Anyone can give you performance information," said PNC's McGoldrick. "What clients want is an OCIO provider that can react quickly to changes in market environments, one that can be robust about what is in the portfolio — just equities and bonds [aren't] good enough anymore — and one that understands risk management and can help mitigate portfolio volatility." Other services that are important include liquidity management or, in the case of a pension plan on the road to termination, glidepath management. For an endowment, the critical issue may be the ability to meet the return assumptions, he added.

For some asset owners, perceived loss of control and loss of transparency are cited as disadvantages of the OCIO model. Aon's Zagortz refuted these claims. "Because of our ability to customize the solution to the client's needs, you only make the changes you want to make. It does mean operating differently, and that change may be perceived as painful," he said. "But the economics often justify the changes." In addition, he

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A DILIGENT SEARCH PROCESS

Finding the right OCIO partner is a combination of quantitative and qualitative elements.

Asset owners often approach the search for outsourced chief investment officers without specifying beforehand what they are looking for in an OCIO arrangement. But doing the work upfront to identify what portfolio management services to shift to an OCIO partner and conducting solid due diligence in selecting that partner is critical to a successful OCIO arrangement, said industry providers.

"We advise clients or potential clients to first identify the problem they want to solve and then approach a range of providers to understand how they might meet those needs," said Jessica Hart, OCIO retirement practice lead at Northern Trust Asset Management. An ill-defined request for proposal does not help either the client or the provider, she said.

A step-by-step approach to exploring an OCIO model can be useful. "First you need to establish the purpose of the pool of assets. Is that purpose core to the business?" said Jennifer Kruse, partner, U.S. investment solutions and client management leader at Mercer. "Then [ask], Do you have the skills and operational expertise in-house to manage

the pool effectively? If the answer is no, then can you find a partner to help? The reality is that it can be hard to find the right partner."

"Don't rush out an RFP," said Chris McGoldrick, managing director of OCIO solutions at PNC Institutional Asset Management®. "First establish what you are trying to accomplish. Know what's working well for you now and what could work better. Then talk to different providers in order to understand and compare different OCIO models." When it comes to drawing up the RFP, limit the questions, he said. "Ask the questions that are most relevant to your decision-making process."

Pinning down non-negotiables in terms of decision-making will help the process of appointing an OCIO provider. Some asset owners may want to retain manager selection and strategic asset allocation, and only offload administrative tasks. Others may want to delegate everything but the top-line fiduciary responsibility around asset allocation.

"Asset owners can find the evaluation process challenging" said Thomas Kennelly, senior investment strategist for OCIO at State Street Global Advisors. The responses that they will get from RFPs, however well-designed, often yield very different, hard-to-compare proposals. "I would encourage asset owners to consider elements beyond performance." For instance, one client may be up 1% on the previous year and another up 20%, he said. "But one of those clients may be a closed pension fund seeking to protect funded status surplus, while the other has a total-return objective."

When doing the OCIO provider search, some benefits may not be obvious at the start. "An important part of the value proposition of OCIO is its ability to leverage the technology and people dedicated to monitoring and trading portfolios," said Kevin Zagortz, U.S. head of portfolio management at Aon. "Asset owners also are able to gain access to investment opportunities in, say, the private markets, that they couldn't access on their own."

Zagortz offered a three-step view of how to assess an OCIO provider. "First there's the strategy piece: Can the OCIO build a strategy that meets the client's needs? Then there's the question of implementation: How does the OCIO choose managers and structure portfolios? Finally there's execution, which can be very labor intensive and operational," he said. Each of the three steps work in concert, and

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BUSTING THE MYTHS ON COSTS

"There's a very pervasive myth that moving to an OCIO model costs a lot more than a traditional consulting arrangement," said Matt McDaniel, partner and U.S financial strategy group leader at Mercer. "The reason that myth persists is because you get much more under the OCIO model. Think about all of the strategy-setting, governance and fiduciary management, and administrative support and trading [in an outsourced chief investment officer model]. It's natural to look at that and conclude, "Gee, I'm doing less, somebody else is doing more. Therefore, I have to pay a lot more for that."

"But interestingly," he continued, "what we've found is that for clients we've transitioned to full OCIO, in almost every case, the cost is comparable and, in many cases, much less than what they were paying [before the move]."

One reason is scale. Large OCIO firms can drive down sub-advisor fees even below what a large defined benefit plan might be able to negotiate. The savings from the scale neutralizes and, in a lot of cases, outweighs the other incremental costs that might be part of the OCIO process.

"The biggest cost of moving to an OCIO provider is the investment of time required to understand the process and do the search," said Jeffrey Palma, OCIO head of public investments at State Street Global Advisors. "It's an inexpensive down-payment on the long-term benefits that OCIO can provide."

"Being on a larger platform should accrue benefits to most clients in terms of paying lower all-in costs," said Kate El-Hillow, global chief investment officer at Russell Investments. "Everything from manager fees to trading costs, depending on your solution, should be more economical."

"The OCIO model should lighten the load," said Chris McGoldrick, managing director of OCIO solutions at PNC Institutional Asset Management ®. "You should consider what you are saving in terms of time and internal resources when you weigh the costs of OCIO."

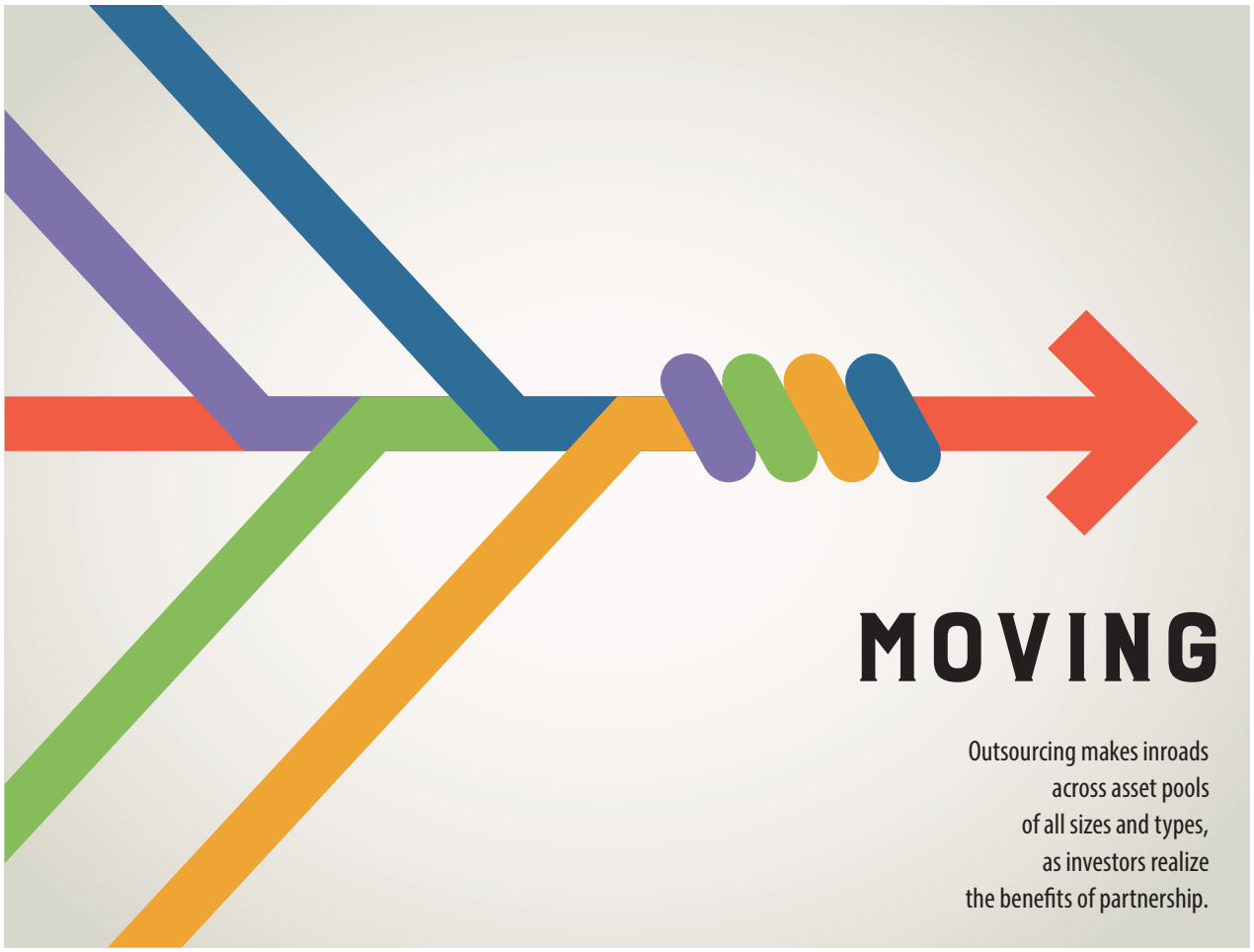
While the overall cost of moving to an OCIO model can be advantageous, asset owners do need to be realistic about the level of services they are getting. "The direct fee for using an OCIO will be higher than the fee you were paying in an advisory model," said Alex Geml, partner at Aon's OCIO client service group. "It is higher because there is a higher level of service and you are outsourcing more of the fiduciary responsibility." That said, the OCIO should be able to lower the overall investment management cost because they bring scale to the table and pass that on to asset owners, he added.

In addition, while moving to an OCIO provider can incur transition costs, it depends on the nature of the transition and the extent of the portfolio that is going into an OCIO arrangement. When evaluating the cost of OCIO providers, transparency is key. "The reality is that there can be a lot of gamesmanship in pricing out portfolios, so you need to make sure you are comparing apples-to-apples," said Jessica Hart, OCIO retirement practice lead at Northern Trust Asset Management.

"Particularly in the not-for-profit space, you can get wildly different asset allocation recommendations from different OCIO providers, and that can influence fees materially," said Hart's colleague, Suzanne Bernard, who leads Northern Trust's not-for-profit OCIO practice. "We try to give the best possible representation of what we will be doing. Just because some [other OCIO provider's] proposed portfolio is less expensive, that doesn't mean that the ultimate program will be less expensive for you."

Another aspect of the cost considerations is to understand explicit costs — manager, custodial and OCIO service fees — and the implicit costs in an overall asset allocation, said Thomas Kennelly, senior investment strategist for OCIO at State Street Global Advisors. For instance, if the delegated portfolio uses more indexing versus more active management, it can mean overall lower fees. "Certainly, though, an OCIO can alleviate some manager, and even custodial, costs through their buying power," he said.

"We want to make sure we are doing things as cost-effectively as possible," said Russell Investments' El-Hillow. "Having a risk budget has been a part of investing for the last couple of decades. Having a fee budget is becoming more and more prevalent with our clients as a way to design solutions that fully meet their objectives."



MOVING AC

Outsourcing makes inroads across asset pools of all sizes and types, as investors realize the benefits of partnership.

"Regardless of the kind of asset pool or the size of assets, we see many asset owners asking how they can use the external resources of an OCIO to make their organization more successful," said Chris McGoldrick, managing director of outsourced chief investment officer solutions at PNC Institutional Asset Management®. "That's presenting us with more demands of increasing complexity and, in some cases, demand for solutions for not just a single asset pool but a group of them — that is, both at the individual and group level."

"We are seeing interest in OCIO from organizations with larger pools of assets," said Samantha Davidson, senior partner and U.S. investment solutions leader at Mercer. "Ten or 15 years ago, OCIO was really focused on the small- to mid-sized plans" that were typically under-resourced internally and needed to outsource investment management. "Now we're regularly seeing plans with assets well in excess of $1 billion looking at OCIO solutions because they have the need for additional support." In many cases, the need for an OCIO arises due to retirement of investment staff, with no obvious replacement, or existing staff being pulled in several directions, she said.

"Larger corporate defined benefit plans are considering outsourcing as the management teams in these businesses are increasingly focusing on their core competencies. They are realizing that they need a specialist to help them on the pension side," said Kate El-Hillow, global chief investment officer at Russell Investments. About 75% of corporate DB plans are still not outsourced, according to Cerulli data, so there's a large opportunity for OCIO providers to help asset owners meet their objectives, she pointed out.

"The bread and butter for DB OCIO solutions for several years has focused on developing a roadmap to get the plan derisked and, eventually, terminated," said Alex Geml, partner in Aon's OCIO client service group. "We've only seen increased interest from that group of potential clients post-COVID-19."

"When we first started seeing interest from the large end of the market, we thought that there would be a lot of interest in saying, 'Why don't we just carve out the liability-driven investing sleeve or a swing portfolio [to protect against downside losses] and manage that through an OCIO framework?'" said Matt McDaniel, partner and U.S. financial strategy group leader at Mercer. "What we've found is that while a lot of discussions might start that way, once they really dig in and understand what the change in the governance model means, most of those organizations decide to outsource the whole portfolio."

"The holistic outsourcing model is becoming more prevalent for large asset pools," said El-Hillow. "It might be that the chief investment officer is retiring or there's an overall change in managing resources at the corpo-

rate level, but we see more people saying, 'If I am going to outsource, let's do it properly, let's not do the pieces.'" Sometimes clients will start with one or two areas where they lack in-house expertise or there are more intense administrative needs, she noted. "We find that these clients often see the benefits of full outsourcing early on."

In the small- to mid-sized DB plan arena as well, Aon is seeing the decision to outsource completely in most cases, said Kevin Zagortz, U.S. head of portfolio management at the firm. In the larger plan space, Aon sees partial outsourcing as more prevalent. "Partial OCIO isn't always a stepping stone to full OCIO," noted Aon's Geml. "Sometimes, when a partial OCIO client becomes more comfortable with OCIO, they will turn to us for more services and move towards full OCIO, but that's not the norm."

CROSS THE SPECTRUM

DIFFERENT ENTERPRISE NEEDS

Another trend is with multinational employers who have pension plans across several countries looking to unify their overall governance structure, said Mercer's Davidson. These organizations can achieve economies of scale through consolidated reporting and global manager relationships via their OCIO provider, she said.

"We see organizations going back to the fundamental question," said PNC's McGoldrick: "'What are we trying to accomplish with this asset pool?'"

He pointed to how the multinational corporations with pension plans in different countries are trying to develop a coherent approach. "The goal can't just be to beat the S&P 500. It has to be a concrete solution that addresses the needs of each plan, while taking account of the overall enterprise requirements."

While the larger organizations have had this strategic approach for some years, it is moving down the size spectrum. "Three years ago, few organizations with less than $400 million were thinking this way; now, even those with cumulative assets of $50 million over multiple asset pools are looking for this type of solution," McGoldrick said.

This enterprise-wide approach is attracting new clients. "When we can see how a whole range of asset pools work together — a DB plan, an operating pool, a [defined contribution] plan, even a self-insurance pool — we can give the client more holistic advice," said Suzanne Bernard, not-for-profit OCIO practice lead at Northern Trust Asset Management.

Many types of asset owners are also coming around to the benefits of hiring an outsourcing partner. "We are seeing a real increase in community foundations looking to OCIO providers to help create robust, flexible investment programs," said Davidson. "By partnering with an OCIO provider, community foundations seek to deliver customized, innovative investment options that strive toward not just superior returns for their donors, but also values alignment and community engagement."

For nonprofit organizations, the need for more sophisticated investment management is driving the search for an OCIO. "If a nonprofit wants a sophisticated portfolio, with allocations to private equity and debt, hedge funds, real estate and real assets, that requires a lot of staff and expertise and it's where an OCIO can [step in and] help significantly," said Heather Myers, partner and nonprofit practice leader at Aon.

OCIO in the public plan arena is in its infancy, noted Aon's Geml. "We are starting to see more [requests for proposals] that ask for quotes for a traditional advisory, investment-consulting approach and an OCIO solution." Most of those that move ahead on OCIO are small- or mid-sized public plans, he said. "The larger plans are kicking the tires of OCIO and are asking questions, so we expect there's more to come in the public space."

"The economics of the OCIO industry are improving and that, in turn, will attract larger asset owners, because these asset pools won't have the scale advantage they once did," said Aon's Zagortz. "This includes more interest from public funds."

Customization is a theme that runs through all OCIO mandates, particularly for clients with multiple asset pools, said Jessica Hart, OCIO retirement practice lead at Northern Trust Asset Management. "We have a client that has a pension plan, an endowment and a working capital portfolio. We were able to deliver a unique solution to each of those asset pools and still create efficiencies for the client."

"We do expect to see more public plans using OCIO," she added. "It's probably going to be driven by a generational shift in management at these plans, and a recognition that they can't continue to add staff or cost in an increasingly complex investing environment."

Although it isn't an area of outsized demand, Northern Trust Asset Management is seeing a definite uptick in interest in niche solutions, such as for a specific asset class or type of manager. "We do get asked whether we can help with a mission-based mandate, and we can assist with those mandates," said Bernard. "Also, we are seeing more hybrid models where there is an advisory relationship on one side and a discretionary relationship for another piece of the portfolio."

DC PLAN SPONSORS EXPLORE SERVICES

Defined contribution plan sponsors are exploring OCIO, particularly those organizations that already have an OCIO partner on the DB side.

"We often see DB and DC plans bundled from an outsourcing perspective," said Thomas Kennelly, senior investment strategist for OCIO at State Street Global Advisors. "They may differ in that the DB plan is hired under ERISA section 3(38), while the DC mandate operates under the different fiduciary rules of ERISA section 3(21)," he said, referring to the Employee Retirement Income Security Act of 1974. "The move to 3(21) would represent a step up in outsourcing from the usual consulting relationship," he added.

How use of OCIOs for DC plans evolves depends partly on the level of paternalism in the sponsoring organization. While some DC sponsors set the investment menu and leave it to the plan participants to make their investment choices, "other corporations are thinking about helping their participants by developing income-replacement strategies and providing longevity-risk solutions," said Hart. "The culture of the organization and philosophy towards the plan will inform the type of OCIO manager or advisor you will want to employ."

Potentially lower investment management fees and better governance are two reasons to use OCIO in DC plans, said Geml at Aon. "Also, the increased litigation in the 401(k) space, often around fees, can make it more attractive to offload some of the fiduciary responsibility for the plan [to an OCIO

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A TWO-WAY PARTNERSHIP

Whether asset owners avail of partial or full discretionary OCIO services, they need to manage strategy and oversight.

The strategic elements of managing an asset pool — investment strategy, asset allocation and the investment policy — "are always shared between the asset owner and the OCIO," said Kevin Zagortz, U.S. head of portfolio management at Aon. "Everything from there onwards is about how you implement the asset allocation and investment policy. You can delegate some [of the implementation], all of it or none of it."

"The conversation around governance and operations starts before an organization becomes a client," said Chris McGoldrick, managing director of OCIO solutions at PNC Institutional Asset Management®. "This upfront time can really make all the difference in terms of leading to better outcomes down the road." Not only does the client need to understand the OCIO's model, but they need to take the opportunity to establish clear expectations for both sides and to set specific goals and metrics. It is the critical moment when the client can define what success looks like to them, he said.

"One of the biggest challenges we face when we take on a new OCIO client is that we still need nimble governance on the client side," said Zagortz. "Investment committees can find it difficult to meet, and voting can present challenges. So, in order to have a true partnership, we still need the client to pay attention to the relationship. Just because you've hired an OCIO doesn't mean you can forget about your [investment] assets. First and foremost, the decision to hire an OCIO is driven by governance."

The cornerstone of governance for any asset owner is the investment policy statement. "We spend a lot of time helping clients improve and enhance their investment policy statement," said Thomas Kennelly, senior investment strategist for OCIO at State Street Global Advisors. "All the operational elements need to be clearly defined to ensure that the objectives and constraints of the asset pool are met. These include, but are not limited to, targets and ranges around the strategic asset allocation, level of discretion, investment managers and vehicles, and method of oversight for both the committee and the OCIO," he said.

A successful OCIO partnership will look different to each client. "With a wider range of asset owners considering outsourcing at some level, it's a flexible proposition," said Samantha Davidson, senior partner and U.S. investment solutions leader at Mercer. "Many large organizations are more comfortable with starting simply with an agreed level of operational support and then maintaining an active role in the other decisions." Over time, they may choose to delegate more to the OCIO provider, she said.

"The best OCIO arrangement is a strategic partnership that is an extension of staff for the asset owner," said Jessica Hart, OCIO retirement practice lead at Northern Trust Asset Management. "It's a truly customized service ranging from strategy development to thought leadership to governance, and all the day-to-day [operational] requests. It's very comprehensive, often replicating what an internal team would have had to do before outsourcing."

"Customization in the OCIO world doesn't need to be overly complex," said Kate El-Hillow, global chief investment officer at Russell Investments. "When the platform is flexible, clients can customize the OCIO arrangement to meet specific objectives, which could be maintaining a funded ratio or a spending policy."

It's always possible to negotiate parameters around an agreed-upon strategic asset allocation. "For instance, a defined benefit plan may want us to manage the hedge ratio, acting as needed and reporting back," said Jeffrey Palma, OCIO head of public investments at State Street Global Advisors. "But they may want to be consulted if we were to use derivative strategies, such as overlays where we would be spending premium for options exposure." Whatever the arrangement, he stressed that it is always important for the OCIO provider to ensure clients are never surprised by keeping them well informed.

The industry continues to deliver on customized approaches that work for asset own-

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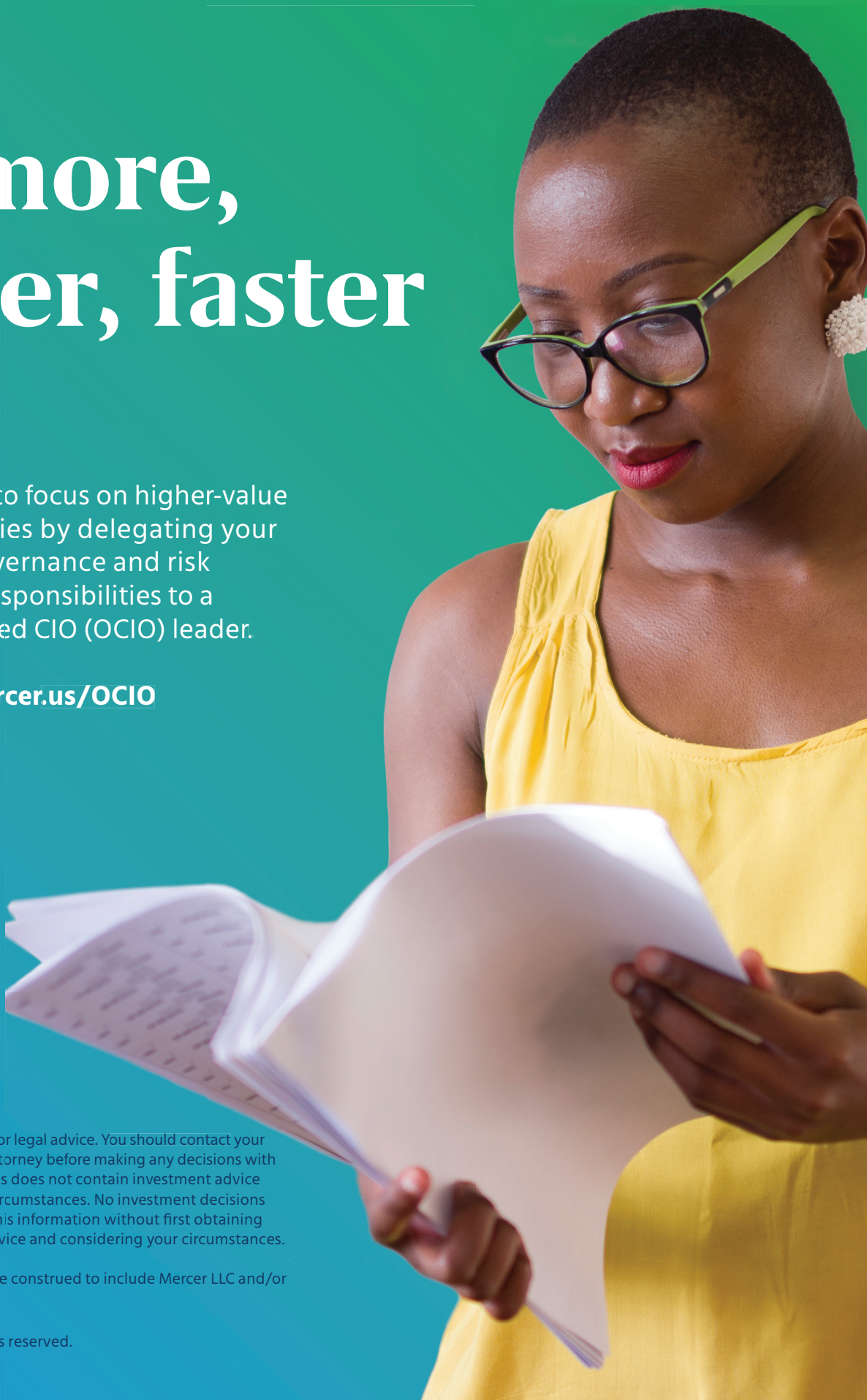

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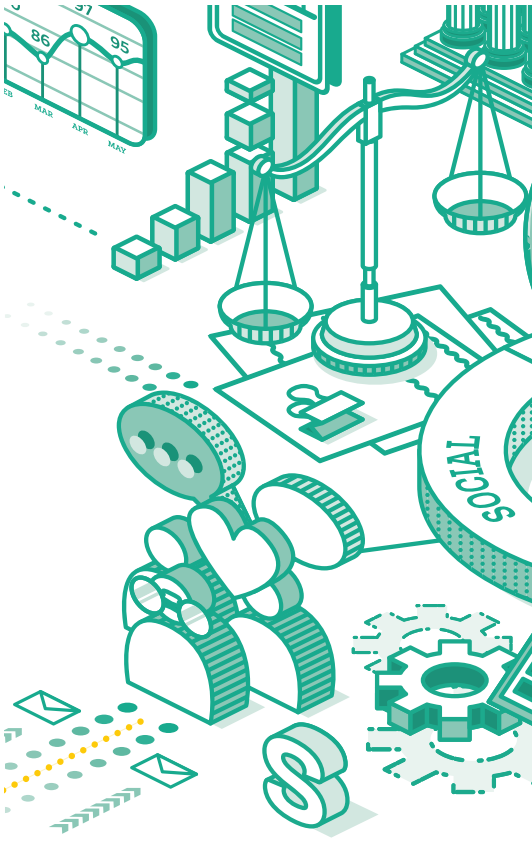
OCIO TAKES ON THE ESG MANTLE



Providers see both challenge and opportunity in responding to the demand for sustainability

Today many institutional investors are squarely focused on environmental, social and governance investing or sustainable investing, and their interest is growing. While their understanding, approach and action in ESG investing can differ enormously, there's no question that investors want to understand the impact of their investments beyond pure return calculations.

For outsourced chief investment officer providers, this rising interest in ESG poses both challenges and opportunities. "There's a ton of interest in ESG," said Chris McGoldrick, managing director of OCIO solutions at PNC Institutional Asset Management®. "The challenge is in the execution. We often hear the question, 'How can we actually put our values into action in the portfolio on a go-forward basis?'"

Kate El-Hillow, global chief investment officer at Russell Investments, suggested that OCIO offers a better way to approach ESG considerations. "OCIO isn't about a product — it is about an overall solution and a service," she said. "OCIO offers a framework that lends itself well to an issue like ESG, where the industry is still trying to think through how to value the risks and opportunities, and how you incorporate that into your investment strategy."

As asset managers are taking different approaches to ESG, the expansion of OCIO capabilities to deliver on ESG integration is going to be extremely important. "Clients need help devising an ESG policy and framework, and then measuring the amount of impact that these policies will have on their portfolio," El-Hillow said. "Then of course, there are the questions around how to do it: Are you going to use ESG-integrated managers or some type of overlay?" This area of exploration is an opportunity for OCIO managers to deliver highly customized ESG solutions, she said.

"The research in the U.S. shows that companies that prioritize sustainability and have solid management teams have proven to have better outcomes," said Samantha Davidson, senior partner and U.S. investment solutions leader at Mercer. "This is driving general interest in ESG across a broader range of clients." While the fullest engagement with ESG is by endowments and foundations, defined contribution plan sponsors are actively exploring the best way to add ESG options to their investment lineup for participants, she said. A number of defined benefit plans, in contrast, are still educating themselves on ESG issues. Both DC and DB plan sponsors are proceeding cautiously in light of regulatory uncertainty around their fiduciary obligations with the ESG approach.

For endowments, foundations and healthcare organizations, sustainable investing and diversity, equity and inclusion are key themes, but "we are also [seeing] an increasing interest from faith-based investors in supporting the communities where they live," said Davidson.

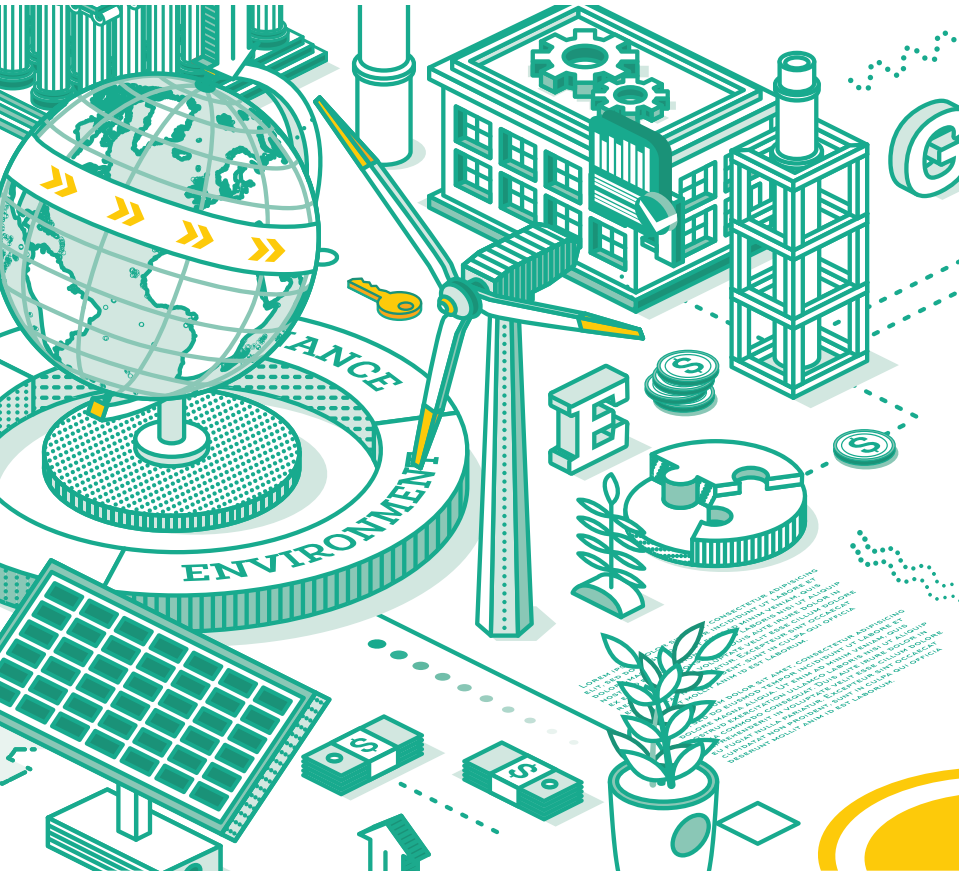
Heather Myers, partner and nonprofit practice leader at Aon, said the firm is receiving more questions than ever relating to issues across the responsible-investing spectrum, and not just from nonprofit clients. Aon evaluates asset managers on how they incorporate ESG factors in their investment process, and also on their diversity, equity and inclusion metrics, she noted.

The type of asset pool is important when considering responsible investing approaches, Myers said. "Initiatives such as impact investing may be best implemented through a foundation," she added, noting that many nonprofits have been searching for ways to use strategies that demonstrate a commitment to social justice that aligns with their mission.

"At Northern Trust, we view ESG as a business risk," said Suzanne Bernard, not-for-profit OCIO practice lead at Northern Trust Asset Management. "We look at it in our capital markets assumptions and have embedded ESG considerations in our manager research process. The idea that ESG is just a not-for-profit issue is a bit dated."

That said, she noted, "it is predominantly not-for-profits that come to us to implement specific [ESG-related] guidelines within their portfolios." For foundations specifically, Bernard pointed to a rise in more proactive ESG mandates, such as mission-based or place-based investing initiatives. "It's not an effort that's broadly applicable to other groups, but is an important trend," she said.

The first step for asset owners interested in considering ESG investments is to review one's current exposures, Bernard said. "Before



you make any changes, find out, for instance, whether you are using managers that are invested in companies with a heavy carbon footprint." Only then can the asset owner make informed decisions about adopting ESG tools, whether choosing to use a negative screen on a portfolio or ESG-friendly index funds, or adding a specific ESG sleeve or taking a more holistic portfolio-wide ESG approach.

Pension plans are asking their OCIO providers for more reporting on ESG exposures and metrics, said Jeffrey Palma, OCIO head of public investments at State Street Global Advisors.

"In endowments and foundations, in contrast, there's active interest in moving into and beyond exclusionary ESG," he said.

Bernard said that some not-for-profit organizations are putting ESG and mission-based investing at the center of their activities. That can call for a different level of support from advisors. "As an example, we have a large religious client with a range of stakeholders, all of whom want to understand how their investment exposures align with their mission," she said. "We provide transparency across their many ESG activities. They use negative screens, proactive investments and even have some specific mission-based investments."

For OCIO providers, clients with multiple stakeholders can mean they need to report to groups that aren't the investment decision-makers and who may not have an investment background. "In this case," Bernard continued, "There are 15 individuals with non-financial backgrounds who are focused on social justice and want to ensure that the assets are deployed in a way that supports the organization's principles and beliefs."

REGULATIONS AND METRICS ARE KEY

"In the U.S., there's less clarity around the use of specific ESG products or requirements under ERISA in the pension world, even as ESG has grown [significantly] in Europe and Asia," said Thomas Kennelly, senior investment strategist for OCIO at State Street Global Advisors, referring to the Employee Retirement Income Security Act of 1974. "With the new [Biden] Administration, there's talk of increased guidance and more codification around ESG." While that has the potential to unleash more demand for ESG investing from pension plans, it has not happened so far, he noted.

"The Department of Labor guidance on ESG investments puts ERISA fiduciaries of both DB and DC funds in a challenging spot," said Alex Geml, partner at Aon's OCIO client service group. "By saying, basically, that the return expectations for any responsible-investing option need to be at least as good as non-ESG options, the DOL has set a very high bar. Although the current administration has said it won't enforce this guidance, the industry remains in limbo." Clearer guidance is likely to be forthcoming shortly, and it is likely to unleash more ESG-related investment activity, he said.

OCIO providers highlighted the increased sophistication of clients who are adopting an ESG focus within their portfolios. In the past, asset owners would put, say, 10% of their assets in an ESG bucket. "It also used to be that clients, begrudgingly, agreed that they were going to sacrifice returns when investing in ESG," said PNC's McGoldrick. Now, however, clients are seeing competitive returns from ESG, along with growing interest, and want to look at their whole portfolio through an ESG lens, he said.

That said, most companies aren't yet implementing a customized approach to ESG investing across all their assets, he noted. "This approach is in its infancy. We are being asked about excluding certain investments, such as fossil fuels, alcohol and tobacco. But we are discussing promoting positive themes through the portfolio, such as using women- and minority-owned businesses," McGoldrick said.

From the standpoint of investment- and enterprise-risk management, asset owners often want to understand how their assets are, and can be, aligned with their organization's ESG objectives. "We expect to see more and more focus on the impact of investments going forward," he added.

"While there's an uptick in interest in ESG globally, it's largely being driven from Europe," said Russell Investments' El-Hillow. "ESG is discussed everywhere, but the way

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An Anchor in Challenging Markets, continued from page 5

said, as the OCIO operates on a more efficient platform, that often leads to greater, not less, transparency.

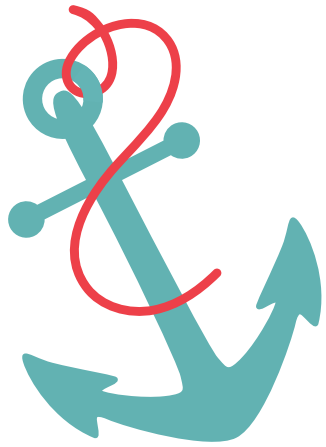
"There's definitely a fear factor when clients first consider discretion, delegation and the notion of giving up control," said State Street's Kennelly. "But it's not a black box solution; it's always a collaboration."

"Transparency matters when discussing the perceived loss of control that some asset owners see with OCIO," said McGoldrick. "We see our role as educating asset owners and investment committees about the investment process, implementation, monitoring and strategy development — and giving them full access to all of this information and experience." In fact, he said, investment committee members can gain more control by being able to dedicate their time to the development of portfolio strategy, the most valuable part of their job.

"The client always has control of their strategic asset allocation, even in a delegated relationship," said Jeffrey Palma, OCIO head of public investments at State Street Global Advisors. "In a fully delegated mandate, we will still work with them to develop the strategic asset allocation, working on an actuarial basis or with their actuary to make sure their investment objectives are met, and then we will build out the portfolio from there."

Heather Myers, partner and nonprofit practice leader at Aon, said that it can sometimes take time for organizations to realize the full benefits of an OCIO. "It may be that the investment committee enjoys some of the work of building a portfolio, but that it places too much burden on the staff [in implementing and monitoring the portfolio]. It can take some education to really understand what you gain from an OCIO versus what you lose," she said.

"Clients have learned how to engage on a multi-asset basis with investment managers and providers on multi-asset strategies, which has created a better dynamic within the OCIO structure," said Russell Investments' El-Hillow. "We have more ways to tailor solutions for clients beyond just asset allocation and manager selection." As an example, she pointed to a DB plan with a glidepath to termination. "As the glidepath develops and the client becomes better funded, the solution needs to change because their liability risks have changed. An OCIO provider can support the ongoing discussions around these strategic asset allocation decisions in a dynamic way," she said.



IMPROVED PARTNERSHIP

A key lesson from the pandemic was the importance of establishing frequent and timely communications between clients and OCIO providers, said El-Hillow. "During the early days of the pandemic, it was important to get the frequency and cadence of discussions with clients right. And that focus has been one of the biggest benefits for clients. Our clients saw how important it could be to have timely conversations with an OCIO provider, and it helped them navigate the difficult market environment."

"When markets are normal, the service aspects of working with clients can be overlooked," said Kennelly at State Street. "But in a crisis, clients need you to make their lives easier. [During the pandemic], we were able to do this by providing information to the [client] staff and committee members quickly and by helping them navigate through the performance updates, [providing] market views, and ensuring seamless service from a custodial, benefit payment, audit and reporting standpoint as well."

Last year, more client demands came in as the markets went through a roller-coaster period, but the increased follow-through has led to a better service overall, one that meets the needs of clients beyond simply performance information, said McGoldrick at PNC. "We're focused on the mission of our clients, helping to provide reassurance around better, more stable outcomes and downside protection," he said. "This often leads to overall better outcomes, which can guide organizations with planning and budgeting and, for pension participants, potentially provide more security" via improved investment management.

"OCIO allows clients to benefit from nimble execution," said Samantha Davidson, CFA, senior partner and U.S. investment solutions leader at Mercer, noting that it can be especially advantageous during turbulent times. "In the first quarter of 2020, our OCIO trading volume was 600% higher than normal. That activity was driven by the need to rebalance, raise cash, meet liability-driven investing triggers, implement dynamic views, and ensure our managers were positioned as we thought they would be."

SETTING THE OVERALL STRATEGY

"What really drives performance of asset pools over time? It's overall strategy, asset allocation and risk-budgeting. These are the big, important decisions that an asset owner cannot, and should not, want to delegate to somebody else," said Mercer's McDaniel. The OCIO arrangement allows asset owners to focus on these issues, while delegating performance monitoring, day-to-day portfolio management, administrative reporting and other related tasks.

"An OCIO brings a higher level of portfolio monitoring than clients can often do themselves," said McGoldrick. "But the critical point is that the OCIO mandate is aligned to your organization's mission. The OCIO's resources and tools are being used to make sure your asset pool is supporting your organization's longer-term goals."

The pandemic allowed many asset owners to dynamically adjust their portfolio exposures in ways that would have been impossible if they had not been using an OCIO. In volatile markets, "governance can be very challenging without an OCIO structure," said Russell Investments' El-Hillow. When clients have already established guardrails that guide OCIO decision-making, "we have the ability to adjust exposures quickly without necessarily acting tactically."

OCIO providers offered a range of proactive ways for their clients to take advantage of market dislocations during the COVID-19 pandemic. One example was the development of an opportunistic bucket, comprising 5% or 10% of total portfolio assets, that the OCIO could use for timely strategies that were not plain vanilla and needed to be acted upon

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An Anchor in Challenging Markets, continued from page 14

in between scheduled investment committee meetings. "We also went back to clients during the pandemic to say that we needed more flexibility in the rebalancing ranges," largely because of the unpredictability of markets, said Alex Geml, partner in Aon's OCIO client service group.

Private assets and private markets have also become a bigger part of OCIO mandates. "In the U.S., there are 15,000 private companies with annual revenues of over $100 million each, versus 2,500 public companies, so it is a huge gap if an investor doesn't have them in their portfolio," said Russell Investments' El-Hillow. "That alone means that it is more relevant for our OCIO clients to consider investing in privates."

As more asset owners understand the need to access the diversification provided by private assets, they also realize that they don't have the internal expertise to manage these asset classes. "These are often complex investments that require a higher level of governance," said Aon's Zagortz. "That's driving demand for OCIO where asset owners can also find a scale advantage."

"Smaller asset owners can often access private assets on a cost-effective pooled basis through an OCIO, thereby capturing an illiquidity premium that was previously unavailable," said Mercer's McDaniel.

As the OCIO market continues to mature with more custom solutions, providers are responding to more granular client-specific needs. "That can mean increases in the type of reporting and operational support that clients expect," said Jessica Hart, OCIO retirement practice lead at Northern Trust Asset Management. "We're also seeing an increase in sophistication on the part of clients, and more demands from them for more transparency and more information about their asset pools."

Given the complexity of meeting portfolio objectives and the more varied asset allocation approaches available today, asset owners cannot underestimate the importance of choosing the right OCIO partner. "Fully outsourcing a portfolio to a trusted partner is a much bigger decision than picking a new U.S. large-cap manager," said El-Hillow. "You need to have a partner that you feel can grow with you, and who has a platform flexible enough to shift with your needs. You need a partner that you trust, that you feel is on the same side of the table as you. The relationship is often described as an extension of staff. But getting the right fit is important, because the OCIO is operating as a fiduciary on your behalf." **O**

A Diligent Search Process, continued from page 7

each needs to be judged against an agreed-upon benchmark, he pointed out.

TAKE A HOLISTIC VIEW

"Comparing and selecting OCIO providers is more challenging than identifying and selecting an investment manager from a database, given the various goals, objectives and benchmarks, particularly for corporate pension plans [who also have] unique profiles," said Kennelly. While there are always quantitative factors involved in choosing an OCIO partner, asset owners should not overlook qualitative measures when making the decision. For instance, "What is the firm's commitment to the business? It's an important question to ask," he said. Also, "What is the seniority of the team? and Will the best team be working with you?"

Asset owners also need to consider the characteristics that are important to them in an outsourcing partner, added Mercer's Kruse. "Flexibility and nimbleness can be key," she said. "You are evolving and so is the market."

An OCIO model, even from a single provider, is rarely a one-size-fits-all proposition. "Be open-minded," said Suzanne Bernard, not-for-profit OCIO practice lead at Northern Trust Asset Management. "Talk to several types of OCIO providers. You may think that a small firm can only do one thing, while a large or independent one will offer a broader range of services. You may be surprised by what you find out!"

"You want to speak to firms that have experience working with what you want them to do for you," Bernard continued. "That may sound obvious, but not everyone asks that question." She also suggested asking for performance [data] that reflects that experience — and following up on references.

"Clients sometimes view the cost or risk of switching to a new provider as higher than we would perceive," said Jeffrey Palma, OCIO head of public investments at State Street Global Advisors. "Clients can also underestimate the risk of staying with existing providers."

LOOK FOR THE RIGHT FIT

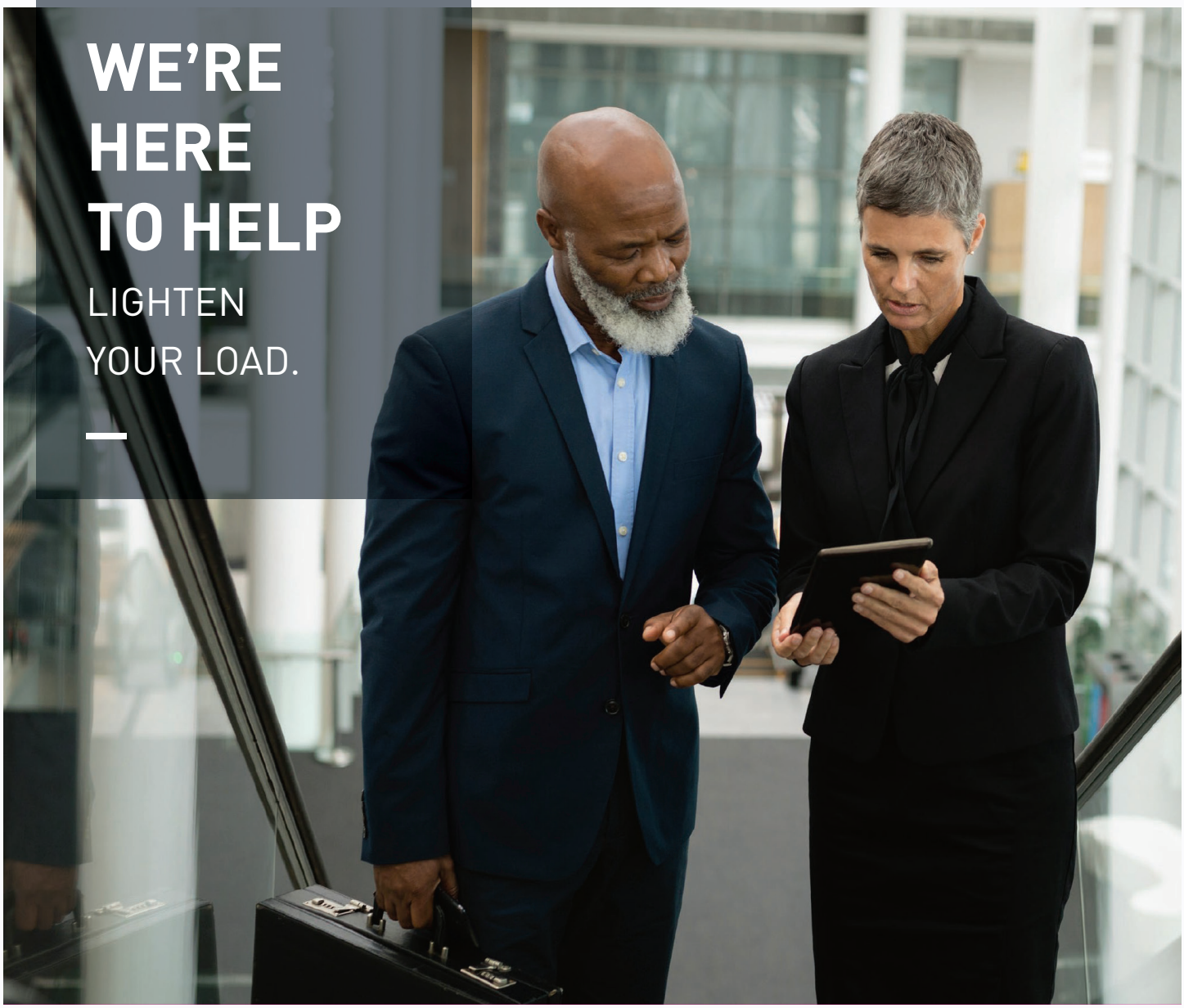
Many companies or asset owners don't have the time or bandwidth to run an OCIO search themselves. "Over the past five years, we've seen a significant rise in the use of OCIO search consultants," said Alex Geml, partner in Aon's OCIO client service group. "Most organizations that use a third-party evaluator find that it helps the process."

"More search consultants have the experience, framework and background to work with clients that are considering the outsourcing services," said Kate El-Hillow, global chief investment officer at Russell Investments. "Consultants increase transparency and help clients measure success, which benefits everyone."

"We always suggest that our potential clients talk to somebody who's in a similar situation," said Mercer's Kruse. "There's nothing like speaking to somebody who's been in your shoes, who's made the same decision that you're considering to help guide your thinking. Third-party evaluators can be helpful. But a peer perspective is, I think, invaluable."

"At the end of the day, the tie-breaker in finals presentations for OCIO is often, simply, 'fit,'" said Chris McGoldrick, managing director of OCIO solutions at PNC Institutional Asset Management. "These people are extensions of your staff. Do you want to work with them? It's not good enough to know that a firm can do the job."

"Somewhat paradoxically, the asset owners that would benefit from an OCIO model the most are often those that have the hardest time making that decision," said Matt McDaniel, partner and U.S financial strategy group leader at Mercer. "Who benefits from better governance? It's organizations that have difficulty making proactive decisions about the direction of their plan." **O**



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Moving Across the Spectrum, continued from page 9

provider]," he added.

The OCIO model does pose some challenges for DC plans. While the plan sponsor has responsibility for the investment lineup, it's the participant that makes the ultimate investment decisions. "An OCIO program needs to marry an investment element with an education component," said PNC's McGoldrick. "The strategy should aim to define the investment goals, but also utilization by participants, which always involves education."

The OCIO provides DC plans with a layer of oversight between the participant and the company, university or healthcare organization," said Jeffrey Palma, OCIO head of public investments at State Street Global Advisors. "The idea is to use an OCIO with investment expertise to build an investment lineup that satisfies individual needs and insulates the parent as well."

Another factor that weighs in favor of hiring an OCIO partner is "if an asset owner is moving their other investment responsibilities to an outsourced model, that's going to reduce the internal expertise available to oversee the DC plan," Palma added.

One of the attractions of OCIO for DC plan sponsors is the importance of having a dedicated legal and policy team that can help closely follow the evolving legal and regulatory environment in order to help the plan sponsor interpret and confidently operate within those guidelines, said Mercer's Davidson.

Plan sponsors often look for support in choosing and overseeing target-date series and other parts of the DC investment lineup. "The challenge here is to make sure that the OCIO isn't just pushing product — their own off-the-shelf target-date series and internal funds," said McGoldrick. "Most clients are looking for an open-architecture approach to make sure they are getting a best-in-class solution."

"We've seen increased desire to bundle in the DC world," said State Street's Kennelly. "You want to ensure the best-of-breed services in this marketplace, and that can mean choosing a different administrator, record keeper, custodian or trustee — and investment expertise. That can mean bringing in an OCIO to drive greater service and cost-efficiency."

HOSPITALS SEEK OUT OCIOS

As healthcare organizations have been at the epicenter of the pandemic disruption of the last 18 months, they have actively sought out OCIO strategies. Some are looking to outsource across their full range of asset pools, while "others are starting by outsourcing the DB plan to explore the relationship, and hoping to use that learning when considering delegation for their operating pools," said Davidson.

"We are seeing more and more asset owners with portfolios over $1 billion considering OCIO, with healthcare organizations accounting for much of this activity," added Bernard at Northern Trust.

While the healthcare sector was obviously very hard hit in terms of business continuity in the last year, it was already a focus of merger activity. "A hospital that is acquiring other hospitals may have multiple plans, a couple of operating funds, perhaps a foundation and also DC plans," said Kennelly. "Managing across these entities can become unwieldy and less efficient, so we expect to see more OCIO activity to enable the organization's staff to focus on their core business."

"Hospital systems often operate multiple pools that have different objectives than a traditional pension plan or a foundation," said El-Hillow at Russell Investments. "An OCIO can help the CIO at the system level understand how the pools work together and impact their business." That can mean paying more attention to metrics like impact to credit rating or cash on hand, in addition to funded status risk of an underlying pension. "The decisions you make at the individual asset pool level often have implications at the aggregate level, so you may need to consider the potential trade-offs," she said. **O**

A Two-Way Partnership, continued from page 10

ers. Aon's Zagortz pointed to a 'joint execution model' with one client who has defined benefit, defined contribution and endowment assets, and who continues to maintain in-house investment staff, although the number of staffers has shrunk significantly. "We have a joint governance committee for the DB plan that requires votes from both Aon and the client on rebalancing, tactical tilting of the portfolio, and some cash and collateral management issues because the client uses overlays," he said. "It's technically a partial OCIO mandate, but we work very closely together."

Importantly, governance isn't just the front-end piece, said Kennelly at State Street. "The back end involves performance attribution, risk and reporting, and how [these impact the] next steps. Of course, that process mirrors the process we follow internally from a governance and decision-making standpoint through our internal audit committee to ensure that all our decisions were made in the best interests of our clients and are reported back appropriately." **O**

OCIO Takes On the ESG Mantle, continued from page 13

that it is being reflected in portfolios varies. We don't think ESG is a product. It's about process, data and thinking through how the ESG secular shift will change investment exposures and risks. Our approach is focused on integrating ESG into the overall investment solution."

OCIO providers are also seeing more queries around DEI-related metrics. "Increasingly, clients are looking to understand the DEI practices of their investment managers," said Jessica Hart, OCIO retirement practice lead at Northern Trust Asset Management. "Investment committees are getting pressure from their boards and other stakeholders to report on DEI. Over the last several years, we've expanded on our long-standing integration of DEI and ESG evaluation into our manager due diligence process, as we view these as important business considerations."

"Research into both public and private companies shows that more diverse boards lead to better outcomes," said Mercer's Davidson. "We have been providing that information to our clients so they can understand how DEI issues affect their current portfolio." Mercer is working with all its asset managers to collect DEI data and offer greater transparency and data consistency across their portfolio investments, she said. **O**

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