planadviser
March 17, 2021 | John Manganaro, PLANADVISER.com

Why and How the OCIO Model Is Moving Up Market

Sources say it's partly due to the growing popularity of ESG investing, but there's a lot more going on to fuel the trend, from increasing market complexity to the emergence of new regulations.

Samantha Davidson, U.S. outsourced chief investment officer (OCIO) business leader at Mercer, recently sat down for a discussion with PLANADVISER to mark her six month anniversary in the role.

Davidson says it has been "quite a busy and unique time" to be working in this space, noting a lot of her time has already been spent on the rapidly evolving topic of environmental, social and governance (ESG) as well as diversity, equity and inclusion (DE&I) investing, among other key areas.

"I had been at Goldman Sachs for 17 years before moving into this role, and it has been a big change for me," Davidson says. "As you know, Mercer services clients globally, so we have the benefit of collaborating with clients to implement ESG programs internationally and are always looking to bring lessons here to the States."

Davidson says the OCIO model has been around as a concept for 15 or 20 years, though there have been some entities using outsourcing for longer than that—say, 25 years.

"However, the trends have really shifted in 2020 and 2021," she says. "Early on, the interest in using OCIOs was very concentrated among small and midsized organization that didn't have strong investment teams within their own organizations. In our experience and in our peers' experience, this is changing, and OCIO is really moving up market in a significant way."

Davidson says the high-level explanation for this development is not so mysterious. Essentially, these larger organizations feel like they need to put their people first and their focus elsewhere, and they want someone to steward their assets in a holistic and trusted fashion.

"Again, thinking globally, we know the OCIO model is well accepted and sought after by organizations of all sizes," she adds. "You can see this especially in the United Kingdom and in the European markets, but we also have many clients in the Asia region and other areas. It's a very global focus for asset owners."

Another factor at play, in Davidson's estimation, is the push among organizations of all types to create value-aligned portfolios.

"This approach has always been popular among our nonprofit faith-based organizations, but it's becoming a much broader trend," Davidson says. "We are working with many different types of clients on this type of thing, and it has accelerated noticeably in the last six months alone. This is one of the trends that, beyond the ESG topic, shows why and how outsourcing is moving up market."

Zooming in specifically on defined contribution (DC) plans, PGIM, the global asset management business of Prudential Financial, has found that more DC plan sponsors are hiring OCIOs specifically to run their plans. Plan sponsors say they are looking to create an institutional-quality investment lineup because they lack the internal expertise to do so and to reduce their fiduciary risk.

Mercer

Josh Cohen, head of institutional defined contribution at PGIM, tells PLANADVISER that by an institutional quality lineup, sponsors mean they want diversified asset classes, including alternatives and illiquid investments, custom target-date funds (TDFs), lifetime income solutions, a mix of active and passive investments and multi-manager and white-label structures for at least some of their menu options.

PGIM notes that only 15% of DC sponsors are using an OCIO manager, but that this jumps to 24% for midsized plans.

"The use of OCIOs in the DC market is evolving, and adoption is still in the early days," Cohen says. He says that as DC plans continue to become more complex, such as by adding in retirement income solutions and annuities, more DC sponsors are likely to turn to OCIOs. "There is also a heightened fiduciary environment out there," Cohen adds.

Davidson agrees with all these points, citing the importance of increased market volatility and the ever-more-complex investing and economic environment unfolding around us.

"It is a big responsibility to be stewarding clients' dollars at a time like this," she says. "There are just so many trends that need to be followed. Another one of these is understanding the lasting impact of the unprecedented and historic levels of stimulus we have seen in 2020 and 2021. As the OCIO provider, this comes down to managing risk, return and volatility in a holistic way, but that's challenged more and more by the fact that traditional approaches to dampening volatility are expected to generate low returns. For certain clients, we are looking to hedge funds to help dampen volatility, for example. There are a range of investment themes we are focused on such as further investing in China or in private markets as a means to position portfolios. We're having in-depth conversations with some very sophisticated clients about these trends and topics."

Davidson points to a related issue that should help propel OCIO services further and further up market.

"Larger and more sophisticated entities may be able to generate their investment view and philosophy, and that's important," Davidson says. "However, having the time to implement, monitor and maintain that investment view in this shifting market environment is another thing entirely. There is a growing understanding that the OCIO model permits the large organizations with their own investment teams to actually take a more sophisticated and customized view about how we can support them, especially in the area of implementation."

Davidson suggests that, in close to 100% of cases, a quality OCIO is going to be able to do a better job at implementation—at documenting the managers' performance, at enacting timely transitions between investments or asset classes, at rebalancing and managing the day-to-day cash management, etc.

"There are very few organizations, even among the premier companies out there today, that wouldn't see it as attractive to hand much of this over to an OCIO," she concludes. "This is often where our bigger clients start, and then over time they identify other areas where we can support them, and our relationship grows." ■

Mercer