GOVERNANCE ISSUES: CAN OCIO FIX AN ABSENTEE COMMITTEE?

HOW DO YOU SOLVE THE PROBLEM OF AN ABSENTEE INVESTMENT COMMITTEE?

With outsourced investment options (commonly called OCIO, which is how we'll refer to these in the remainder of this report) becoming more popular in the institutional investment community, we have considered what types of governance issues an OCIO might be able to solve for organizations and investment committees.

This is not to say that OCIO is only useful for dysfunctional committees, but it is true that we usually get calls when something is broken. Sometimes this is related to the consultant: performance hasn't met expectations, or the client feels that the consultant isn't proactively managing the relationship, or perhaps there has been turnover on the account. But governance is also a key concern, and many of our clients and prospective clients have wondered if OCIO could solve a nagging problem: absentee investment committees.

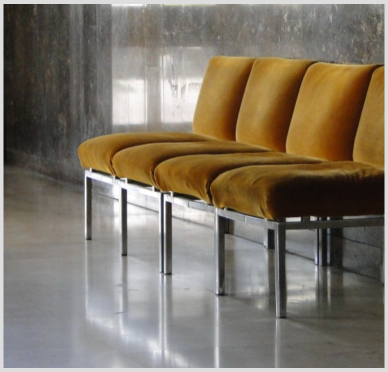
ABSENTEE COMMITTEE MEMBER ARCHETYPE

Having served on the boards of non-profits and having worked with many more as consultants and endowment directors, we understand this particular governance problem intimately. It can take many forms.

The serial volunteer: Bob's biography proudly lists his participation on the boards of several well-known non-profits, but he rarely attends scheduled investment committee meetings and does not participate in most discussions or decisions.

The dog ate my homework member: Susan attends scheduled committee meetings but has not done the background reading and preparation needed to add value to investment discussions; valuable meeting time is spent answering her questions.

The one whose cousin is a broker: Anita loves to bring new investment ideas to the table – unfortunately, most are either too



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expensive or too esoteric for the committee to invest in. They also have not been vetted by an independent consultant. Valuable time is wasted both for the committee and the investment consultant researching and rejecting these investments.

The pillar of the community: Anything Randall says goes, even if most of the investment committee thinks it is the wrong decision. After all, no one argues with Randall. He has been on the board for over ten years.

What all of these archetypical volunteers have in common is a tendency to distract the investment committee from its purpose. Too much time is wasted in valuable committee meetings, time that is needed to set the broad direction of the investment portfolio and monitor the service providers. You can't force grown-ups to do their homework, especially not volunteers, but political considerations usually mean that organizations also cannot simply replace problem members.

SOLUTIONS FOR A THORNY ISSUE

There are several potential ways to handle this thorny issue, including:

A. Rely on the consultant's advice while waiting out the terms of uncooperative committee members (not the most proactive way to handle it, but it does happen).

B. Bring in an external governance consultant to revamp the committee and put into place new policies and procedures.

C. Bring some committee responsibilities in house.

D. Outsource some or all of the committee's responsibilities to a third party.

EXPLORING OPTION D—OCIO

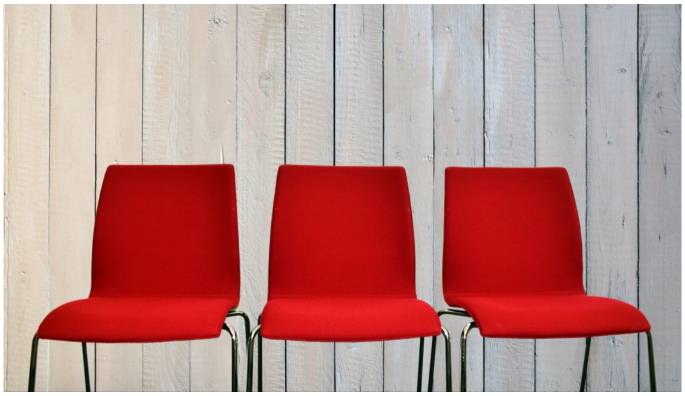
We've been asked, is there really a difference between effectively rubber stamping a consultant's every recommendation and simply giving them discretion to make the decision?

In our minds, there are three primary differences:

1. The level of oversight

As with any industry and any firm, some investment consultants are more skilled than others. OCIOs should have policies and procedures in place where investment decisions are vetted and approved. This ensures that one consultant doesn't "go rogue" or make decisions that don't reflect the best thinking of the firm.

In the case of a traditional investment consultant relationship, there may not be the same level of consulting firm oversight – after all, *the committee members* are the additional level of oversight in the latter case. If the committee is



not performing that level of oversight and simply takes all of the consultant's recommendations on faith, a committee had better hope they have an A-team consultant guiding the portfolio!

2. The fiduciary liability

You cannot pay someone to completely absorb

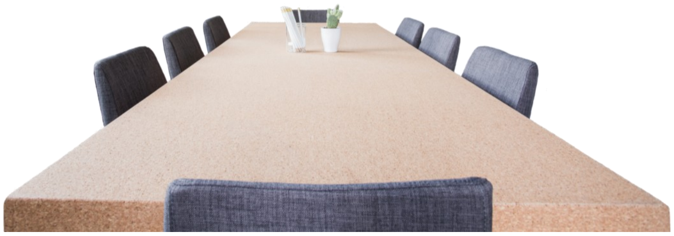
your fiduciary liability. Full stop.

The investment advisor, whether a non-discretionary consultant or OCIO, acts as a fiduciary alongside the investment committee, but the level of fiduciary responsibility differs. In an OCIO relationship, the committee does shift its fiduciary liability from evaluating the investments themselves to evaluating the advisor, but they must still fulfill this duty. The buck always stops with the committee.

3. **The feeling of personal responsibility**

At the end of the day, a consultant who only provides advice may not feel personally responsible for the assets he or she advises on - especially if performance suffers when the consultant's recommendation is not taken. The level of responsibility is vastly higher for a named investment manager than it is for an advice provider. An investment manager lives or dies based on the results of his or her portfolio. A consultant, put simply, does not.

These distinctions tilt the scale in favor of absentee committees seriously considering OCIO solutions. However, it's important to note that ultimately, this does NOT solve the tricky problem of a checked-out investment committee in our minds. Why not?



WHO OVERSEES THE OCIO?

The committee retains the fiduciary duty to evaluate the OCIO provider, both initially and on an ongoing basis.

To evaluate investment managers (and we include OCIOs here, as they effectively act as multi-asset managers for the portfolio) requires a specialized skill set. In fact, that's one of the main services that an investment consultant provides in a traditional, non-discretionary consulting relationship.

Most investment committees include members with financial services experience or investment knowledge, often enough to set big-picture investment policy decisions and to weigh in on the long-term asset allocation of the portfolio. Investment committees are usually responsible for these tasks in either traditional non-discretionary or OCIO relationships, so we agree that this is the appropriate skill set to look for when selecting investment committee members. Unfortunately, this is not the same skill set required to perform in-depth due diligence on managers.

Investment committees who choose OCIO as a bandage, therefore, have not solved the initial problem of non-engagement, and they have created a higher bar for themselves in fulfilling their fiduciary duty.

The committee who was not fulfilling its previous fiduciary duty to evaluate investment managers based on advice given by a traditional investment consultant is not likely to suddenly start fulfilling this exact same role when it comes to evaluating the outsourced portfolio manager, the OCIO.

The committee must consider using an additional service provider in these situations: an investment expert who can perform an evaluation of the OCIO.

CAN OCIO FIX AN ABSENTEE COMMITTEE?

THE VALUE OF A THIRD PARTY OCIO EVALUATION

As outsourced investment solutions become more popular for institutions such as pension plans, endowments, and non-profit asset pools, so too do third-party evaluation and monitoring services who assist the investment committee in properly selecting and overseeing the OCIO.

These providers act as a “consultant” to the investment committee, assisting the committee in performing its crucial fiduciary responsibility of selecting, overseeing, and evaluating the outsourced investment solution. Typically, this review is performed annually and should be well documented. Just as OCIOs come in many flavors, so too do OCIO evaluation services. They range from truly independent advisors, who offer no institutional investment consulting or OCIO services of their own, to investment consultants and outsourced CIOs who serve in a monitoring capacity for non-investment clients.

We believe that there is great value in selecting a truly independent option, as consulting firms have a baked-in conflict of interest that can color the analysis. Just as the investment consultant should be providing advice independent of relationships with investment managers, monitors should provide advice independent of consultants.

ABOUT ALPHA CAPITAL MANAGEMENT

Our firm was founded in 2006 by Brad Alford. We are located in Atlanta, GA. After spending nearly two decades at large investment firms, Brad wanted the freedom and flexibility to provide customized services to his clients. An independently owned advisory firm with an eleven-year history, Alpha Capital seeks to provide unbiased advice to our partners with our investment-oriented services and solutions.

CONSULTANT SEARCH SERVICES

Consultant Search Services (CSS) grew out of a client’s need for independent advice and assistance in running the investment consultant search process for their $100M institutional portfolio. Our principals have experience on both sides of the table, having served as consultants and institutional investors, and we are able to drive a better result for our clients while simplifying the search (RFP) process.