CLIENTS GIVE CONSULTANTS A GREEN LIGHT FOR OCIO

THE GROWTH OF OCIO, AND REASONS WHY INVESTMENT CONSULTANTS EMBRACE IT

Virtually unheard of a decade ago, the outsourced Chief Investment Officer ("OCIO") marketplace has exploded. OCIO providers had more than $1.7 trillion in fully discretionary or partial discretionary assets under management ("AUM") in early 2018, on a projected base of over $6 trillion total "outsourceable assets." OCIO assets in the US have grown significantly over the past decade, and OCIO assets under management are expected to continue to grow at low double-digit rates for the foreseeable future, according to projections from Cerulli Associates and *Pensions & Investments*. In fact, Cerulli projects that US OCIO assets will increase by $671 billion over the next five years alone.

With such attractive growth prospects, it is no surprise that all sorts of firms are entering the market to offer institutional OCIO solutions. Alpha Capital Management tracks nearly 100 different firms offering OCIO services. Many of the OCIOs who have been most successful in attracting clients are consultants.

In this research paper, Alpha Capital Management offers our thoughts on the three primary reasons investment consultants are embracing OCIO, along with three challenges they face with this service model.

WHY CONSULTANTS ARE EMBRACING OCIO:

1. Client demand
2. Higher fees
3. Scalability

CHALLENGES CONSULTANTS FACE AS OCIOs:

1. Performance
2. Operations
3. Conflicts of interest

Contact us about this report at www.alphacapitalmgmt.com.

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ALPHA CAPITAL MANAGEMENT

GREEN LIGHT FOR CONSULTANTS AS OCIOS

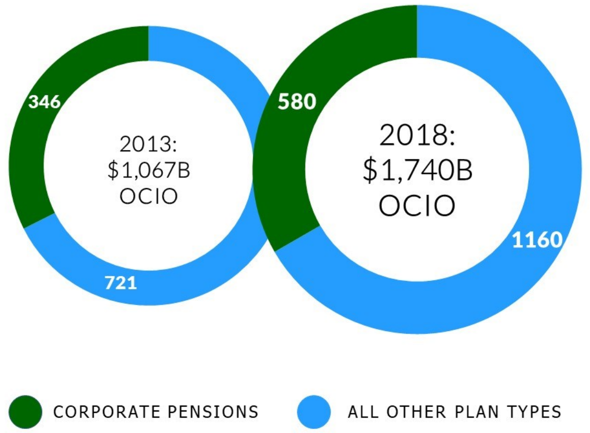
OCIO IS IN DEMAND

OCIO is growing because clients demand it. Why now? Let's look at a few real-life examples from Alpha Capital Management's search clients.

A $200M frozen pension plan finally saw their funded status top 90%. The CFO was thrilled. But by the time they went to lock it in, the markets moved against them. When we were called in to do a search, the funded status was back in the mid-80s. This number was so important to the CFO that he asked finalists if it could be pushed to him daily via text message. They went OCIO.

Pensions like our search client are a huge part of the OCIO market. This was true five years ago, and it is still true today. As *Pensions & Investments* reported in June 2018: "Large managers of discretionary OCIO assets said one of their biggest sources of new business in the past year and expected to be going forward is from corporations contemplating the fate of their defined benefit plans." Defined benefit plans have kept pace with the massive growth of OCIO and still represent a third of the global OCIO marketplace.

FIGURE 1: PENSIONS EMBRACE OCIO

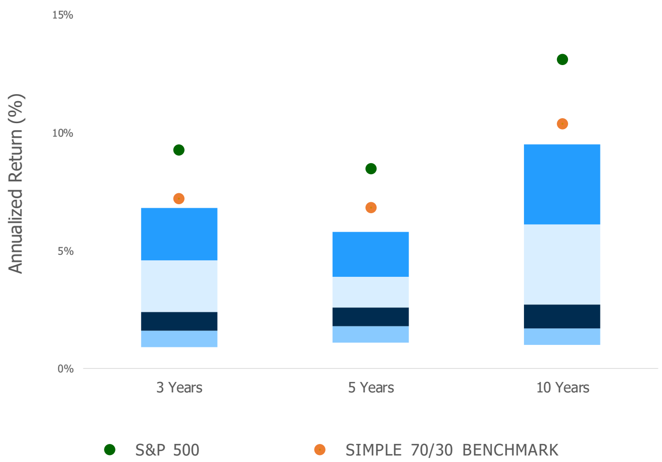


Total OCIO AUM data from Pensions & Investments (P&I). Corporate pension AUM based on Casey Quirk % breakdown applied to P&I total AUM figures. See BlackRock's report, "Pension OCIO Buyer's Guide" for more details.

Here's another example. We worked with a non-profit with about $500M in assets. Their returns weren't awful, but they were below their peer group median and trailing public market benchmarks over the past 3, 5, and 10 years. "We must be terrible at managing money," thought the board. They went OCIO.

It has been a tough market cycle for diversified investors like our non-profit client. The S&P 500 has beaten InvestorForce's entire institutional universe, as shown in Figure 2.

FIGURE 2: SIMPLE INDEXES BEAT INSTITUTIONS



InvestorForce data as of 12/31/18. Boxes represent quartiles (top and bottom 5% excluded) for the entire institutional universe. n = 3,296 for 3 years; 3,008 for 5 years; 2,256 for 10 years. Simple 70/30 Benchmark is 70% S&P 500 and 30% Barclays Aggregate.

Of course, we are not arguing that the S&P 500 Index is a fair comparison, or even a reasonable one, for a diversified portfolio. But it is undeniably a visible, well understood, and highly discussed benchmark. Even against the simple blended index in Figure 2, institutional portfolios have not kept up with the US market. Broad index returns may not mean as much as meeting client-specific goals and objectives, but these comparisons still matter to clients.

We believe OCIO has grown so rapidly because it has benefited from two huge tailwinds: frozen pensions and underperforming plan sponsors.

GREEN LIGHT FOR CONSULTANTS AS OCIOS

OCIOS ARE FORMING ALL OVER (OR REINVENTING THEMSELVES)

It is no surprise that Wall Street is busily coming up with solutions to meet strong client demand… or giving old solutions a new name. Here's a quote from one of our 2018 OCIO search responses:

> *"WE HAVE OFFERED OCIO SOLUTIONS SINCE THE FOUNDING OF OUR BANK MORE THAN 150 YEARS AGO."*

Sure, if you count trusts as OCIO. Or think about big asset managers who have been offering multi-asset solutions with in-house investment products for decades. Or the private wealth manager who works with a high net worth individual and ends up managing the family foundation. For that matter, what about a billion-dollar family office? Discretion is the rule, not the exception, in all of these markets. It is our little corner of the institutional investment community where non-discretionary consultants and oversight boards are the rule, not the exception.

Have you taken a close look at the OCIO lists lately? Charles Skorina's list had 81 firms on it in mid-2018. *Pensions & Investments* listed nearly 60 OCIOs with more than $1B in outsourced assets in early 2018. We maintain our own list, and it has almost 100 OCIOs on it. That would make for a great headline, wouldn't it? *Firm X launches the one hundredth OCIO.*

But if you take a closer look at the firms on any of these lists, you see a lot of groups creatively repurposing trust departments or multi-asset class solutions, and plenty of firms with a large private wealth management business and a small institutional client base. The barrier to call oneself an OCIO is low - if there is a barrier at all. Let us exclude trusts and private wealth groups for now and focus on the OCIOs who are leading the way and gathering most of the assets. Look at the top 30 or so OCIO firms on any list. Many (but not all) are investment consultants.

CONSULTANTS EMBRACE OCIO

Why are consultants embracing OCIO? First and foremost, their clients are asking for more help. The marketing pitch we hear for OCIO goes like this: "it leads to stronger governance and an improved decision-making process, and it allows investment committees to focus on strategic decisions rather than getting bogged down in the details of running a complex portfolio. The service model bears an increased cost to compensate for the additional fiduciary liability of the OCIO."

Consultants may not charge enough for advisory work (although our clients disagree). Try going to your advisory clients and asking for a 100% fee increase – you're more likely to get fired than to get a client to agree. OCIO, though, has given consultants the opportunity to reset the market perception of value. An institution may be willing to pay twice as much for OCIO. This is an important factor in the explosion of OCIO offerings by consultants.

OCIO also offers an attractive opportunity for consultants to grow more quickly using scalable solutions. Traditional investment consulting services are hard to scale. Portfolio management can be simpler and more scalable under an OCIO model. Instead of a consultant with 10 clients performing 10 individual asset allocation projects and 10 manager searches with 3 candidates per search, an OCIO does one asset allocation project and hires one manager per slot and then pushes it out to all 10 clients.

Despite these benefits, we believe consultants are finding OCIO to be a two-edged sword. With the benefits of higher fees and a more scalable service model come several key challenges. We focus on three main ones: performance, operations, and conflicts of interest.

CHALLENGES FACING CONSULTANTS-TURNED-OCIOS

CHALLENGE #1: PERFORMANCE

A constant source of frustration at our firm is trying to get a consultant to quantify the value of their advice (one reason we think they can't charge as much as they should). Think back to our non-profit client who blamed themselves for their poor performance. Who *is* responsible for returns? The board selected the asset allocation, but the consultant did the asset allocation study. The board picked the managers, but the consultant recommended them. It's hard to parse out who is responsible for performance in an advisory relationship.

With OCIO though, performance responsibility rests squarely on the consultant-turned-OCIO, good or bad. Take a look at this statistic from Cerulli's most recent OCIO research study:

> *100% OF NON-PROFIT RESPONDENTS LIST **INVESTMENT PERFORMANCE** AS THE #1 THING AN OCIO MUST DELIVER*

We don't believe that consultants have fully embraced this responsibility yet. When prospective clients ask for performance, a common refrain from consulting firms is, "we cannot show an OCIO track record because every client is different." Clients may have different goals, but relative performance or composites of clients with similar goals should capture these. Institutions must be able to see a track record in order to judge whether an OCIO is likely to deliver their #1 expectation, investment performance.

CHALLENGE #2: OPERATIONS

One reason OCIO is so popular for non-profits under $250M (who, as a rule, are chronically understaffed) is operations. Investment portfolios have gotten extremely complex. Paperwork can be a nightmare, especially for alternatives with partnership agreements, side pockets, capital calls, distributions, and everything else to manage. Operational efficiency is a big selling point for OCIO solutions, but it's also one where consultants don't have a natural skill set - they must build it or buy it.

It also presents an interesting conundrum for consultants selling OCIO solutions to investment committees. Investment committees make the investment decisions, but they usually don't know how the sausage is made. Operations staff handle portfolio implementation, but they don't sit on investment committees. Consultants tie investment discretion and operational authority together into one OCIO package, but committees may view these as completely separate decisions. And committees may not *want* their consultant to sell them new and expensive investment solutions, which brings us to our third challenge.

CHALLENGE #3: CONFLICTS OF INTEREST

One thing the institutional investment consulting community does exceptionally well is align their interests with their clients. These long-term relationships are built on the client's ability to trust their consultant. Serious conflicts of interest (like accepting money or Masters tickets from asset managers, earning 12b-1 fees and other commissions in addition to advisory fees, or selling proprietary products) are rare in the consulting industry these days, and those that exist are typically well disclosed and well managed. Offering OCIO services alongside non-discretionary services, however, opens the door to brand new, serious conflicts of interest that must be managed. Now consultants have something to sell non-discretionary clients, OCIO, that increases revenue. Consultants are building proprietary products in an attempt to scale OCIO solutions – another potential conflict. Consultants are held wholly responsible for OCIO track records but not for non-discretionary client performance, incentivizing them to allocate top quartile, limited capacity managers to OCIO clients in the hopes of improving their performance record. The fee differential between non-discretionary and OCIO clients incentivizes firms to allocate their best resources to the line of business with higher revenue potential. These are just a few examples. The OCIO industry is just beginning to grapple with these serious conflicts.

TAKEAWAYS

OCIO, we believe, is here to stay. The service is in high demand from clients because it offers potential solutions to challenging problems facing today's plan sponsors: a difficult return environment, the need to build and oversee complex investment portfolios, and ever-increasing operational demands. Consultants are well placed to offer attractive OCIO solutions to clients, and many established investment consulting firms have successfully grown their OCIO practices.

But be warned: consulting firms must find a way to offer OCIO services without breaking the trust of their clients. We encourage consulting firms to think carefully about the potential conflicts of interest inherent in offering OCIO alongside traditional non-discretionary services, and to proactively and transparently address those issues with well-designed policies. December performance woes may be forgotten by mid-January, but clients have a long memory for bad behavior. It is time for the OCIO industry to evolve.

ABOUT ALPHA CAPITAL MANAGEMENT

Alpha Capital strives to improve the outcome for the investor. Our firm was founded in 2006 by Brad Alford, and our four employees are located in Atlanta, Georgia. With more than twelve years of history, Alpha Capital seeks to provide unbiased advice to our clients with zero conflicts. We offer no institutional OCIO or consulting services, and our active Principals own and control 100% of our firm. We believe our independence is crucial and enables us to sit on the same side of the table as our clients.

CONSULTANT SEARCH SERVICES

We perform OCIO and non-discretionary investment consultant searches for institutions. Our clients to date have represented over $20B in assets. We also offer evaluations for institutions who aren't ready for a search but want an in-depth audit of their current OCIO or consultant. Our Principals have investment credentials and decades of experience as investors, portfolio managers, and investment consultants. We drive a better result for our clients while simplifying the search or evaluation process.