OUTSOURCED CIO: NOT A SILVER BULLET

Outsourced Chief Investment Officer ("outsourced CIO" or "OCIO") solutions have exploded in popularity in the past few years – although these types of relationships have existed for far longer. What is an OCIO? In the classic investment consulting relationship, an organization (for example, a corporation, government office, endowment, or foundation) works with a consultant to determine an appropriate policy and asset allocation for the investment pool. The investment consultant monitors the pool and advises on asset allocation changes, investment manager replacements, and other related issues. The organization retains discretion over the investment pool and may choose whether to follow the consultant's advice; hence, these are "non-discretionary" relationships. In a discretionary (or OCIO) relationship, the consultant has the ability to implement changes without direct approval from the organization, acting as the chief investment officer.

As a consultant search service, we help organizations select investment consultants. These days, most clients ask about OCIO – even when the purpose of the search is to replace a non-discretionary investment consultant. Given the current level of attention OCIO commands in the news, it is not surprising. However, there is a significant amount of misinformation floating around the industry regarding outsourced CIO providers, and some carry a great deal of risk for organizations. OCIO is sometimes touted as a miracle cure or silver bullet. We hope to address some of the most common – and most dangerous – misconceptions in thinking about OCIO providers.

OCIO ABSOLVES AN ORGANIZATION OF ITS FIDUCIARY DUTY

We see this alluded to frequently in marketing materials from OCIO firms. Unfortunately, it is wrong. Nothing can release an organization (and by extension, a Board of Directors) from its fiduciary duty. Outsourced CIO providers can serve as co-fiduciary, but the organization remains a fiduciary for the investment pool. The organization also has the duty to evaluate the OCIO service provider on a regular basis, just as they have with a traditional consultant. It is tempting to turn things over to an OCIO and focus on other responsibilities (indeed, it's one of the selling points of this service), but the organization puts itself at risk with this behavior.

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OCIO IS A NEW SOLUTION

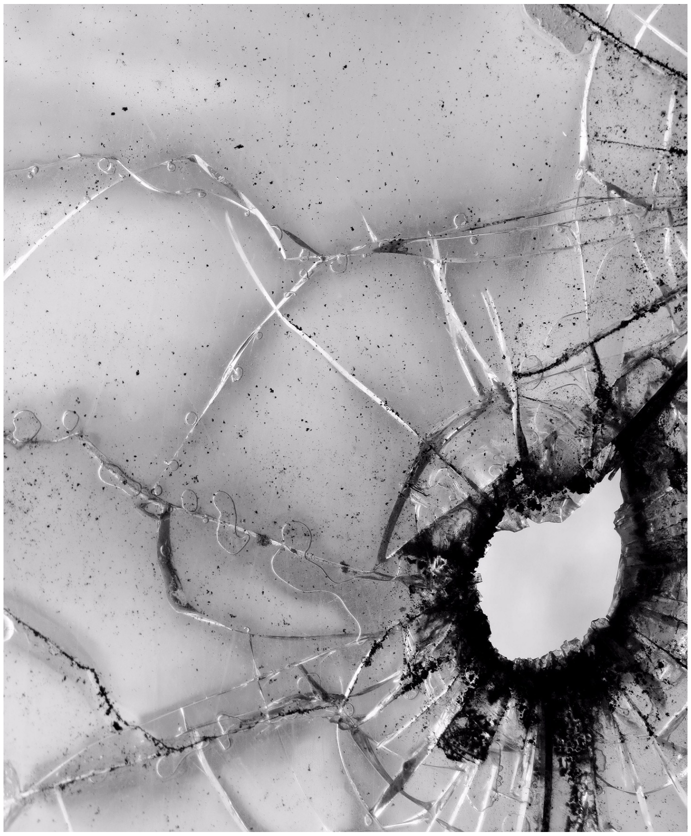
This one is widespread but not particularly dangerous. OCIO has existed, under one name or another, for over twenty years. This type of arrangement is especially common in the endowment world, where investment teams broke away from larger endowments and created specialized investment models for use by small-to-mid-sized endowments and foundations. In recent years, however, the use of the "outsourced CIO" moniker has risen in popularity – and the number of firms offering these services has exploded. Even traditional investment consultants are getting into the space, with many now offering services along a spectrum from non-discretionary to full discretion.

OCIO FEES ARE SIMILAR TO TRADITIONAL CONSULTANTS

As with any business-to-business solution, price and service levels vary widely between firms. Fees for OCIO solutions are often two to three times more annually than a non-discretionary investment consultant. Given high dispersion and the lack of a standard service model, plan sponsors and institutions must carefully evaluate the costs involved and the services provided in each firm's quote to fulfill their fiduciary duty. We recommend that organizations issuing an OCIO RFP request bids from a few firms who offer non-discretionary options (or both). This provides a benchmark when assessing fees.

OCIO PAYS FOR ITSELF

As we have just learned, OCIOs can cost significantly more than traditional investment consultants. One explanation for the difference is the level of service provided. OCIO providers like to say that it costs less to outsource than to build capabilities in-house. That depends. A 0.30% annual fee costs a $350M organization over $1M in fees per year, which could probably pay for an internal CIO, an assistant, and third-party investment research. Another justification OCIO firms use to downplay their fees is that outsourcing requires less support staff to implement investment changes (filing documents, initiating money transfers, etc.). In our experience, staff members spend only a fraction of their time on investment-related activities. Without proven investment results and measurable decreases in payroll, OCIO fees can prove hard for organizations to swallow.



OCIO FIRMS HAVE RESULTS

Performance is one way to draw clear comparisons between investment managers. Most investment managers, especially those who work with institutional clients, claim compliance with Global Investment Performance Standards (GIPS), a globally accepted methodology for calculating and presenting performance information. Prospective

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clients are able to directly compare investment manager results to measure skill. It's ironic that consultants who would never hire an investment manager without a track record ask to be hired without providing their own.

Although we request performance information for representative client accounts in our non-discretionary and OCIO RFPs, it is hard to evaluate. Traditional consultants are not usually compliant with GIPS, and performance varies widely between clients due to varying IPS restrictions, use of alternative assets, individual investment managers, and whether the client implements the consultant's advice. It seems that OCIO providers should clear this hurdle and be able to provide GIPS compliant performance (and there are some who do) – however, more customized OCIO providers face the same issues that traditional consulting firms do; clients have different investment restrictions, different managers, and different objectives.

OCIOS MINIMIZE CONFLICTS OF INTEREST

Many OCIO firms (and traditional consulting firms) offer proprietary investment vehicles. These can take many forms, but a common one is an alternative fund-of-funds (for instance, private equity or hedge funds). These proprietary funds have potential benefits, including access to alternatives for smaller clients. But they also have potentially serious conflicts of interest. An OCIO firm has an incentive to invest clients in their fund-of-funds to earn more fees (if, for example, the fund includes performance incentives or management fees). In the private wealth world, this is known as double dipping, and the SEC takes it seriously. We have seen firms who rebate these fees back to their clients and others who do not. Investors need transparency into the layers of fees they pay to their OCIO providers as well as information on other potential conflicts of interest.

No solution is perfect for every client. With these misconceptions cleared up, our hope is that organizations can make the best decision to meet their needs, whether that is OCIO or non-discretionary consulting or something else entirely. OCIO is certainly not a silver bullet, but it can be a great weapon for an organization. Unsure if it is right for you? Interested in evaluating your options? Give us a call — we are happy to share our perspective.

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.