KLINGENSTEIN FIELDS ADVISORS

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OCIO Matchmaking:

A Relationship Guide for Non-profit Organizations

Klingenstein Fields Advisors (KF Advisors) Non-profit Insights *provides thought leadership, events, and perspectives dedicated to issues and opportunities facing non-profit organizations. Contributors include outsourced chief investment officer (OCIO) specialists from KF Advisors as well as experts from the philanthropic community and leading professional organizations that serve them.*

Introduction

"A prudent question is one-half of wisdom."
— Francis Bacon

Although the OCIO model is relatively new, its growth trajectory has been quite impressive. Since 2010, OCIO asset growth has exceeded 30% annually and now stands at approximately $2T. At the same time, the number of providers has risen from a handful a decade ago to several hundred today. Underlying this trend are the very real benefits associated with the model. These include greater accountability assumed by the consulting firm, more support for the non-profit's financial staff, and a sharper, better-placed focus on asset allocation by the investment committee. Another benefit not often cited is that by giving over day-to-day management of the portfolio to an OCIO, there is less chance of being stung by the agency effect, which refers to the unintended harm caused by listening to one's client.

The explosion of choice increases the likelihood that there are OCIO providers with the potential to add considerable value to the management of non-profit investment funds. However, the large number of firms from which to choose—each boasting its own special advantages—has made the process of selecting the "right" OCIO very challenging.

Based on our experience as a manager of non-profit investment pools and, privately, as investment committee members/chairs serving on many non-profit boards, we have identified key questions every non-profit should ask potential OCIO firms. These questions should help board members and selection committees refine their search criteria and more effectively vet potential candidates.

1. What is the scope and depth of services provided?

The OCIO model has evolved. What was once an investment-only assignment has become—for some forward-looking firms—a full partnership whereby the OCIO takes an active role in helping its clients set financial goals and track their progress. These firms use an integrated approach across the organization's financial ecosystem. Beyond managing the investment program, they provide a means of understanding the interrelationships of the investment pool with capital projects, operating budget shortfalls, balance sheet strength, and fundraising capabilities.

This deeper level of engagement creates a more effective and productive partnership between OCIOs and their clients. It may lead the consultant to question or confirm asset allocation and spending policies and helps keep investment portfolios and practices in close alignment with an institution's overall financial picture. It is especially valuable for small and mid-size institutions that may be limited in manpower and/or lack the specialized expertise and resources to address key financial issues facing the non-profit. This greater integration also makes the correct consultant selection even more critical.

2. Is the OCIO an industry specialist?

Endowments, foundations, and other non-profit entities are often better served by an OCIO that specializes in charitable organizations versus a generalist whose core market may be corporate, Taft-Hartley, or government pension funds. Your non-profit has distinct strategic needs and objectives related to the fulfillment of its mission. An OCIO with deep non-profit expertise can develop appropriate and effective solutions and is well suited to offer informed guidance on a range of important issues, including spending strategies, donor development, rating agency and/or debt management, and monetization of underutilized hard assets. Without non-profit domain expertise, OCIOs too often struggle to understand the basics, including the different approaches required on behalf of operating non-profits, as opposed to grantmaking organizations.

Group decision-making at a non-profit looks nothing like that found in a comparatively hierarchical corporation or even other types of entities served by general OCIOs. The need to be sensitive to a broad array of stakeholders at the charity often leads to a search for consensus. This can take time and typically key board and finance committee members have significant time constraints. OCIOs with experience in working with non-profits can navigate these challenges and frame discussions to introduce and effectively execute strategies. These specialist OCIOs often have members of non-profit boards on their own teams and understand how to balance the needs of your stakeholders from donors to grantees. They can communicate with your board members "trustee to trustee."

3. Is the OCIO the right size to be my true partner?

When selecting an OCIO, finding the right "fit" is important. Some boards or investment committee members view larger, nationally branded OCIOs with a favorable eye. Indeed, these larger firms have the advantages of great resources and reach. However, too often these consulting firms assign less seasoned staff to clients whose assets are below their average relationship. Since the quality of the advice is only as strong as its weakest link, and that link resides at the nexus of the client-consultant relationship, the value of the firm's advice may be compromised. Larger firms also tend to suffer higher turnover in the junior ranks, which can create a lack of continuity in service and a recurring learning curve regarding your institution's needs.

Size is negatively correlated with the ability to customize. Optimal portfolios should be constructed with both capital market assumptions and the unique situation of the non-profit organization. What are the liquidity requirements of the endowment? Is the foundation sun setting? How are the institution's operating results trending? Too often the sole focus by large OCIOs is on implementing a model portfolio without carefully understanding and taking into account their clients' specific situations.

A reasonable general rule is to consider an OCIO firm that is proportionate in size to your own non-profit. If you are a small to mid-size organization, you may find that the service platform of a specialized OCIO is better suited to your needs and expectations than those of a large, nationally recognized firm.

4. Will the OCIO build the right portfolio for your organization?

As discussed above, the "right" portfolio is one that knits together prescient, well-reasoned capital market projections with your organization's particular situation. Given the required high level of portfolio customization, the OCIO should also provide commensurate breadth and depth of investment solutions. Inquire about the array of vehicles utilized (from separate accounts and co-mingled funds, to partnerships and overlays). What are the OCIO's views and practices regarding passive investing? Will the OCIO use alternatives and if so in what way? Does it offer discounted pricing, reduced minimums, or access advantages? The prospective OCIO should provide insight into its investment process highlighting how, when, and for whom it recommends the use of alternatives and in what way it balances the use of these investments with the need for liquidity – especially at times of portfolio stress.

Some OCIOs serving endowments and foundations use a single core portfolio and/or a series of pre-allocated sleeves with which to dial up or down exposures. While there are some advantages to achieving scale through using this approach, it is, by definition, rigid.

5. Does the OCIO manage risk effectively?

Eleemosynary boards are entrusted with safeguarding an organization's assets and ensuring its ability to continue pursuing its stated mission. This means risk management is of paramount importance.

In considering OCIOs, ask their consultants to define risk. They may point to a statistic – standard deviation – rather than an aspiration or a fear. These latter definitions of risk should be client-driven and might be expressed along the lines of: "not being able to adequately expand our Feed the Hungry program," or "not keeping up with inflation and thereby reducing the impact of our grant program." In most circumstances, the organization's definition of risk can and should be translated into its portfolio posture.

An OCIO must be able to demonstrate its risk management process and approach to risk mitigation. This process should apply to manager and, if relevant, security selection as well as to overall portfolio construction. The firm should also explain how it differentiates risk reporting from risk management. Does the OCIO use a risk budget and if so how and when is it employed?

A true fiduciary partner knows what risks are expected to be taken, what exposures exist, and how these risks impact performance. This awareness extends beyond the investment portfolio to risks inherent in running a non-profit organization.

6. Is performance competitive?

Investment performance is a critical determinant of whether an organization is optimizing its asset base to realize its mission. Finding an OCIO that can deliver competitive returns, then, is a key fiduciary responsibility of board members.

Unfortunately, at least until now, there has been no standardized way to define or measure performance, largely because there is no such thing as a "standard" portfolio. Instead, most portfolios and their benchmarks tend to be custom designed to meet each organization's distinctive investment policies, objectives, and mandates.

A promising solution has recently surfaced in the form of the AlphaNasdaq OCIO indices. These are based on "anonymized account-level return streams, asset allocation and metadata self-reported directly by OCIO firms." The AlphaNasdaq OCIO indices are constructed to represent the broad OCIO market and the nuance differences across subcategories, such as plan type and risk profile.

While the hurdles to making apples-to-apples comparisons in OCIO performance persists in some form, these new indices go a long way to enhancing the usual steps provided below:

- Ask providers to show the percentage of their clients that beat their custom benchmarks over a variety of time periods and market cycles.
- Ensure that providers show a representative sample of portfolios and do not cherry-pick the best performers.
- Insist on net, not gross, returns and for actual, not back-tested, performance.

7. Is the price right?

Paying a fair price for OCIO services is also an important board-level responsibility. But, as with performance, comparison shopping in this market is challenging, to say the least. This is because OCIO fees are determined by many of the same considerations that drive performance differences: client type and size, scope of mandate, and the expected scope of alternatives expected in the investment program.

Consider the following when weighing the price to value relationship in OCIO pricing:

- Start by reviewing industry average fees from a neutral source e.g., NACUBO or the Council on Foundations. Make sure you refer to averages for institutions like your own in size, type, etc.
- Demand fee transparency on the part of OCIO candidates. Have them break out the fees you are likely to pay, including the OCIO fee, direct investment management fees, carry/incentive fees, transaction-related fees, and administrative fees.
- Weigh the range of services offered and their relative value to your organization. In addition to investment management, a more expansive OCIO may provide thematic education, valuable financial guidance, and related services that should be considered when evaluating the overall fee.

8. Is there another way?

Of late, a cottage industry of search consultants has sprung up offering clients an attractive alternative to a DIY approach. These search consultants provide customized RFPs, a list of high potential OCIO candidates, and RFP response analysis. They attempt to array information on candidate OCIO firms on an apples-to-apples basis and may even score short-listed firms on various factors.

Better search consultants will improve the chances of a successful match. Their approach can help committees stay on track and avoid unproductive diversions. These search consultants may even negotiate fees on behalf of their clients.

Summary

An OCIO can be a valuable partner in helping non-profit boards meet their fiduciary responsibilities and realize their organizations' missions. But as the OCIO model evolves and more providers enter the market, finding the right OCIO for your organization can be a challenge.

In this paper, we have provided some guidelines that can help you screen for the best candidates. The application of these guidelines may be especially appropriate for small to mid-size non-profits as they try to identify outsourced providers that are most closely aligned with their specific needs and requirements.

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