White Paper No. 49

The Outsourced CIO Model

Greycourt

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Over the past decade, and accelerating rapidly in the last few years, the so-called "outsourced Chief Investment Officer" model for delivering financial advice has grown very rapidly. In the experience of many advisors, client requests for discretionary advice now outnumber client requests for more traditional non-discretionary advice. The purpose of this paper is to define what an outsourced CIO model is, identify why it has become so popular, distinguish its advantages and disadvantages relative to non-discretionary advisory services, and suggest how investors might think about choosing between the two models.

What Exactly Is the Outsourced CIO Model?

First, a Look at the Traditional Non-Discretionary Advisory Model

When investment consulting firms – the first "open architecture" firms – appeared on the scene in the early 1970s, their clients were the huge pension plans and endowed institutions of the time: the IBM pension plan, Harvard University, the Ford Foundation. These large organizations boasted both in-house investment talent and investment committees populated by sophisticated professionals. They wanted to make all important decisions themselves, and therefore they looked to the consultants only for *recommendations*, especially regarding asset allocation and manager selection. In other words, investment consulting began, and remained for many decades, a non-discretionary, advisory-only model for delivering investment advice. The consultants made recommendations, but the clients decided what to do.

Over time, other, smaller investors (pensions, endowed institutions and, ultimately, families) followed the lead of the big organizations and began to engage investment consultants to advise them on their portfolio needs. Because the consulting model had always been non-discretionary, it continued to be non-discretionary, even though these new clients were quite different from the traditional consulting clients: typically, they lacked in-house investment talent,[1] access to sophisticated investment committees, and their asset bases were much smaller. These are, of course, related issues.

The possible weaknesses of the non-discretionary model for these new clients tended to be disguised by the long and powerful Bull Markets that characterized most of the 1980s and

[1] A recent NACUBO-Commonfund study of smaller endowments indicates that only 11% of funds between \$100 million and \$500 million employed in-house CIOs. See *2009 NACUBO-Commonfund Study of Endowment Results*. The percentage for families is far lower.

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1990s. But matters began to come to a head around the turn of the century, when the Tech Collapse caught many investors off-guard. These investors had often ignored their advisors' advice to rebalance out of rapidly appreciating growth and tech stocks, and the collapse of 2000 – 2002 hit their portfolios very hard. It was at this point that clients began to consider the possible merits of asking their advisors to take discretion over their portfolios.

What had been a steady trend toward seeking discretionary advice became a virtual torrent following the catastrophic market environment of mid-2007 to early 2009. As noted above, today many advisors are seeing more requests for discretionary advice than for non-discretionary advice. And given the likelihood – in the New Normal investment environment – of lower returns and higher volatility, we expect the outsourced CIO model to be a trend that is here to stay.

Documenting the Trend Toward the Outsourced CIO Model

According to a recent Casey Quirk study, just in the past four years fully outsourced assets from investors of all kinds have more than doubled.[2] The same study reported that US-based institutions will outsource more than half a trillion dollars in investments by the end of 2012.

But it's not just institutional investors that are moving in this direction. According to a recent survey by the Family Wealth Alliance:[3]

- Approximately four in ten wealthy families have outsourced discretionary investment management and now use an outsourced CIO model.
- Among smaller family offices (those with $500 million or less in assets), two-thirds use an external advisor on a discretionary basis.
- A third of all single family offices think they lack sufficient expertise to analyze investments themselves (up from 20% a year earlier). This rises to 50% for SFOs with $100 million to $500 million in assets.

It seems apparent that an ever-increasing number of "smaller" investors (those with assets below about $500 million[4]) have concluded that the benefits of discretionary advice

[2] *The New Gatekeepers: Winning Business Models for Investment Outsourcing* (Casey Quirk, 2008).

[3] *Inaugural 2009 Single-Family Office Study*, Family Wealth Alliance. The study is available for purchase from the Family Wealth Alliance.

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outweigh whatever the detriments might be. But what exactly *is* the outsourced CIO model and how does it work?

What's Driving the Trend Toward the Outsourced CIO Model?

The key investment issues all investors face are selecting and implementing the correct asset mix for the portfolio, instituting good governance and policy implementation practices, engaging capable managers and monitoring the performance and risks of the portfolio. This seemed to be a manageable task in the 1980s and 1990s, but over the past decade it has become quite daunting. There are a variety of reasons for this complexity, including:

- Much more volatile and difficult capital markets.
- The perception that returns will be lower in the foreseeable future, and therefore the urgency of avoiding even small investment mistakes.
- Limited investment resources at the client level, combined with rising costs.
- The desire to add uncorrelated assets to the portfolio, especially in the non-traditional categories.
- Difficulty accessing best-in-class managers, especially hedge funds.
- Difficulty in fulfilling fiduciary obligations in the wake of greater scrutiny and regulation of financial activity.
- The overwhelming task of sorting through the plethora of financial instruments to determine the best fit for the portfolio.

More broadly, many advisors produced horrible results for their clients in 2008, and those advisors that were non-discretionary tended to take refuge in their non-discretionary status, ducking responsibility for the debacle: "We only made recommendations – you made the decisions." Clients want their advisors to step up to the table and accept responsibility for portfolio outcomes, and advisors are much more willing to do so if they have discretion.

It is also important to note that acting with discretion allows advisors to demonstrate the value of what they do in bottom-line dollars. Historically, investors have been willing to

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[4] More important than the size of the asset pool is the ability or willingness of the client to hire in-house investment professionals and to organize and maintain a well-functioning investment committee. These capabilities are far more common above the $500 million level than below it.

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pay high fees to money managers and hedge funds (who, on the whole, subtract value from portfolios) but have insisted on paying low fees to investment consultants, who, on the whole, add significant value. By managing portfolios in a discretionary manner, formerly non-discretionary advisors are able to demonstrate the value they add and, importantly, to get paid for it.

Finally, it is clearly the case that many investors who formerly took a firm, hands-on approach to the management of their portfolios decided, after 2008, that, "We give up! We're not very good at this and we need to outsource it!"

The Outsourced CIO Model Today

When investors talk about the outsourced CIO model, what they are referring to is the use of advisory firms to manage their portfolios on a discretionary basis, without seeking the clients' consent (at least within limits) to make changes. Overwhelmingly, the "advisors" clients are hiring are the same open architecture firms that formerly operated on a non-discretionary basis, but which have begun offering discretionary management as a result of client demand. These firms are basically using the same set of tools they have always used with clients – skills in asset allocation, manager selection and performance reporting – but are simply exercising these skills on a discretionary basis.

How Does the Outsourced CIO Model Work?

Although each firm has its own twists on the model, in general the outsourced CIO model works as follows.

Establishing a Risk Budget

Since risk is by far the most important issue associated with managing portfolios, the advisor will work with the client to establish a risk budget for the account. Typically, this risk budget will be built around the expected price volatility of the portfolio, but it may also incorporate such risk-management metrics as expected downside risk, maximum expected loss over a given period of time, Value at Risk, and so on. Ultimately, the risk budget will usually be expressed as a long-term, strategic asset allocation target with ranges around which the portfolio will be allowed to depart from the target. Except with the client's permission, the advisor may not stray from this overall portfolio design.

Return Expectations

Returns will necessarily fall out of the decisions made about risk, but it is useful to express return expectations up-front in any event.

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Liquidity Needs

This is both a "real" issue – some investors simply need more liquidity than others – and a "perception" issue: some investors are more comfortable with more liquidity than others will feel they need. In general, the willingness to trade liquidity for increased return should be addressed.

Tactical Positioning of the Portfolio

Typically, ranges will be established that will allow the portfolio to fluctuate above or below the strategic targets, either as the result of market fluctuations or as the result of intentional tactical tilts imposed by the advisor. Again, except with permission the advisor may not exceed these ranges.

Opportunistic Ideas

One important way to add value to a portfolio is to allow it to take advantage of occasional opportunities made available by dislocations in the capital markets. (Typically, these will be behaviorally-driven dislocations, occasioned by greed or panic on the part of other investors.) The client and the advisor will agree up-front on the percentage of the overall portfolio that can be allocated to such opportunities.

Manager Selection

In general, manager selection will be left entirely to the discretion of the advisor. However, it is important that the client and the advisor agree on such key policy issues as the degree to which markets are efficient (and, therefore, the relative allocation to active versus passive management).

Diversification

The degree of diversification versus concentration is an issue that should be settled up-front. This will include manager concentration issues.

Investment Costs

Typically, clients and advisors will want to optimize costs (as opposed to minimizing or ignoring them). But if the client or advisor has a different view of investment costs, those views should be expressed up-front.

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Withdrawals from the Portfolio

It's the client's money, of course, and in that sense all or part of the capital can be withdrawn at any time. But if wealth is to be maximized, there should be a clear understanding between the client and the advisor about the approximate size and timing of expected withdrawals, especially if they are to be large.

Tax Management

For taxable accounts, the degree to which taxes will be managed, and the specific techniques that will be employed, should be addressed. Clients will differ on the relative importance they place on tax savings (a bird in the hand) versus the expectation of improved long-term returns.

Specific Guidelines

If the client wishes to impose specific limits on the advisor's discretion (in addition to the broad limits described above), those limits should be specified: prohibited investments, quality guidelines for fixed income securities, use of derivatives, socially responsible metrics, proxy voting, etc.

Performance Reporting

Most advisors provide full quarterly reports with briefer monthly updates. If something more is desired, this will need to be negotiated up-front. In discretionary accounts, some clients want to be notified every time a trade is made for their account, while others will be happy to wait for quarter end.

Unwinding Trades

Most discretionary advisors will be willing to unwind any trade that makes a client uncomfortable, albeit at the client's risk. However, this issue should me made clear.

The Written Policy Statement

All the above, plus any other topics of importance to the client or the advisor, should be memorialized in a written policy statement, which will become the "bible" for the advisor who is managing the portfolio.

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Separate versus Commingled Accounts

Once the portfolio goes live, it may be managed as a separate account, or, depending on its size and the practices of the advisor, it may be commingled with other investor funds.

Advantages and Disadvantages of the Outsourced CIO Model

Advantages of the Model

In deciding to engage an outsourced CIO, investors are seeking the following competitive advantages over investors who work with non-discretionary advisors:

Reduced opportunity costs.[5] In a non-discretionary engagement, the advisor typically works on a quarterly cycle of issuing performance reports and making recommendations. (More frequent cycles tend to be cost-prohibitive except for the very largest clients.) Thus:

- On Day 1 the advisor formulates an investment idea.
- Several weeks later, this idea is converted into a written recommendation for the client.
- The recommendation, together with the quarterly performance report, is mailed to the client.
- The client, who is abroad, eventually gets around to looking at the report and the recommendations.
- A meeting or conference call is set up to discuss performance and recommendations, typically at least several weeks in the future, given everyone's busy schedules.
- Following the meeting or call, the client takes the matter under advisement.
- Eventually, the client approves, modifies, or disapproves the recommendation.
- The advisor then implements the recommendation as-made or as-modified. We are now at Day 70.[6]

[5] "Opportunity costs" refers to the price movement that occurs between the time an investment idea is formulated and the time it is executed.

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No, this isn't the norm, but it's not an outlier outcome, either. Indeed, we've heard stories of clients who waited nearly a year to act on a recommendation. (We've also heard stories about advisors who formulate recommendations but then routinely wait three months to circulate them to the client base.)

When a good open architecture advisor is evaluating a manager, one key issue is how hard the manager works to minimize opportunity costs across the investment decisionmaking process. Yet that same advisor often pays little attention to opportunity costs in the context of its own advice to its clients.

One very important advantage of the outsourced CIO model is that opportunity costs are virtually eliminated: the advisor formulates an investment idea and executes it almost immediately. Especially in the likely low-return environment of the New Normal, minimizing opportunity costs matters more than ever. For many investors, this one advantage of the outsourced CIO model will prove to be decisive.

More sophisticated portfolio designs. If the client must make all decisions about the portfolio, the great likelihood is that the overall strategic asset allocation – which will, more than any other factor, determine the investment outcome – will be less sophisticated than it would be if the advisor is charged with the day-to-day management responsibilities. Unless the client is a skilled investment professional, the client's comfort zone regarding investment strategies is likely to be suboptimal.

Expanded opportunity set. As a corollary to the first point, outsourced portfolios tend to include more asset classes, more tactical bets, more opportunistic ideas, and so on, thus offering a higher probability of capturing market inefficiencies for the client's benefit.

Focus on the primary mission or interests. Allowing families to focus on their core interests or other business, professional or philanthropic activities, and allowing institutions to focus on their core missions, is one of the advantages of the outsourced CIO model.

Enhanced fiduciary oversight. If the comments made above about opportunity costs, portfolio design and expanded opportunity sets are accurate, fiduciary oversight may be enhanced by moving to an outsourced CIO model. In addition, of course, the outsourced CIO model ensures that professionals are managing the portfolio constantly, not once a quarter when the family or investment committee meets.

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[6] Note that if the client uses an investment committee, this can result in additional delays. Committee members are usually busy folks and it's often difficult to find a free meeting date in common. They are also often strong personalities, which can result in decisional gridlock.

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Intellectual capital. In a non-discretionary engagement, once the client has indicated its lack of comfort with certain strategies, tactics or managers, the advisor tends to simplify the recommendations it brings to the table going forward, either consciously or unconsciously. In a fully discretionary engagement, the client's portfolio benefits from the full intellectual capital of the advisory firm.

Eased diligence obligations. When the client is making the final manager selection decision, the client will often meet with the manager and/or conduct in-depth conference calls. After the manager is hired, the client may feel obligated to conduct periodic on-site visits, to hold regular calls, and so on. Many clients lack the time to carry out these diligence activities, and many others lack the skill to make them meaningful. Under the outsourced CIO model, the client delegates all this to the advisor, although the client can usually meet or speak with managers as desired.

Disadvantages of the Model

There are certainly disadvantages of the outsourced CIO model, which will make it inappropriate for many investors.

Giving up control. Although it is often merely an illusion (since most clients can't effectively second-guess advisor recommendations), many investors want more control over their portfolios than is possible in the outsourced CIO model.

Selecting a poor discretionary advisor. It's very difficult to evaluate firms that are offering outsourced CIO services (see the discussion below), with the result that there is always the danger that a client will have turned its capital over to an incompetent advisor. Incompetent non-discretionary advisors tend to do less damage to portfolios than incompetent discretionary advisors.

Forfeiting the benefits of open architecture. Some outsourced CIO advisors use their own investment products (or products they are paid to use), rather than true arm's length managers and products. As we note below, moving from a non-discretionary open architecture advisor to a discretionary conflicted advisor is a poor trade. The best possible trade for many investors would be to move from a conflicted non-discretionary advisor to an open architecture discretionary advisor.

Investment education. One way for an investor to educate itself about portfolio management – and, therefore, to become a more effective client – is to participate meaningfully in the portfolio management process. While outsourced CIO advisors also offer client education services, many investors will find there is no substitute for getting their hands dirty.

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Reduced fiduciary oversight. We noted above that in some cases moving from non-discretionary to discretionary management can improve fiduciary oversight of portfolios. But if the advisor is a poor or conflicted one, fiduciary oversight can suffer.

Cost. Most advisors charge more for discretionary advice, so if cost is an issue this factor could tip the scales in favor of the non-discretionary model. However, many advisors are raising the price of non-discretionary services, in part because in many cases they are non-discretionary-in-name-only. If the advisor is really making all the decisions, without meaningful client input, then the advisor is really responsible for the portfolio and should be paid appropriately.

Is the Outsourced CIO Model Right for You?

Clients will likely have strong opinions about the appropriateness of the outsourced CIO model for their portfolios. However, in the following paragraphs we identify some of the motivating factors that lead family and institutional clients to migrate to the outsourced CIO model.

Family Investors

It is enormously difficult for families to attract and keep top-tier investment talent. It is nearly as difficult for a family to organize and maintain a high-functioning investment committee.[7] Finally, most families made their money outside the financial sector and have little skill in managing liquid capital. These factors began driving families toward the outsourced CIO model earlier this century.

A more recent issue is the changing regulatory environment as it affects families and, especially, family offices. Recently passed legislation (the Dodd-Frank bill) eliminates the "small advisor" exemption from registration as an investment advisor, on which many smaller family offices relied. While the legislation exempts family offices from registration going forward, it leaves it up to the SEC to define a "family office." It is not clear that family offices that advise in-laws and ex-spouses will be exempt from registration, or even that family offices that advise other than strict lineal descendants will be exempt.

One way for a family office to avoid any need to register with the SEC is to go out of the investment business altogether by granting investment discretion over their assets to an advisor who is already SEC-registered.

[7] Although there are spectacular counter-examples, among families with assets under about $500 million, well-functioning investment committees are the exception, rather than the rule.

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Institutional Investors

Except for the smallest institutions, even institutional investors without in-house investment staffs have tended to engage non-discretionary advisors and to work with those advisors through investment committees. In some cases this practice has worked well, but in many cases it has resulted in mediocre or worse investment performance, complicated issues surrounding the management of the investment committee, and serious opportunity costs associated with the quarterly meeting cycle of the committee.

Poor relative performance could be tolerated (or, rather, unnoticed) when market returns were well above historic norms, as during the 1990s. But in a low-return environment that is complicated by declining charitable giving and the need to re-focus on core missions, institutional investors who cannot afford in-house talent might wish to re-think their non-discretionary advisory relationships. Acting as a co-fiduciary, the outsourced CIO advisor can bring many strengths to the relationship.

How to Select a Good Outsourced CIO Advisor

Evaluating potential candidates for an outsourced CIO mandate is fraught with all the complexities associated with evaluating any new financial advisor, but it also has a few wrinkles of its own. Here is a checklist of issues to focus on:

√ Pardon us for being prejudiced, but it makes very little sense to trade in an open architecture non-discretionary advisor in order to retain a conflicted discretionary advisor. All the problems with conflicts of interest apply in spades to outsourced CIO advisors. Stick with outsourced CIOs who maintain a strict open architecture platform.

√ Many advisors advertising outsourced CIO services are simply responding to client demand and have little experience or resources to support provision of these services. Tactical portfolio adjustments in particular can be dangerous if the advisor has little real investment experience.

√ Is the advisor offering a one-size-fits-all approach? If so, run the other way. Especially when discretion is being given to an advisor, the overall portfolio design, risk level and return expectations need to be tailored to the client's unique objectives and risk tolerance.

√ Does the advisor have a clearly articulated investment process which is uniformly applied across all portfolios?

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√ How deep is the advisor's experience in public and private markets?

√ How robust are the advisor's manager selection resources?

√ Has the advisor put in place a sophisticated risk management process?

√ Does the advisor have a culture centered on client relationship management? Even if the advisor is doing a good job, failure to communicate openly with clients can result in serious misunderstanding – as many hedge funds learned in 2008.

√ Does the advisor maintain relationships with multiple service providers? Is the firm able to "unbundle" such services as custody, brokerage, banking, etc.?

√ How deep is the performance reporting infrastructure? Are reports timely and accurate? Can the advisor offer customized reporting solutions?

√ How transparent is the advisor with respect to underlying managers? Are manager profiles available to clients? May clients meet with or call managers used in their accounts?

√ If the account is taxable, how much experience has the advisor had managing private capital? How actively are taxes managed and what techniques are used? It is unfortunately the case that most firms that offer outsourced CIO services have little or no experience managing taxable capital.

√ If the account is institutional, does the advisor have expertise in asset/liability management?

Summary

It is certainly the case that the outsourced CIO model is not right for every investor. However, the rapid growth of the model indicates that it is here to stay. Investors who have not yet considered discretionary management might wish to take a look at the advantages and disadvantages of this approach to the management of their capital.

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