

THE INVESTMENT MONTHLY

WHO'S YOUR OCIO?

The existing investment and governance model for most foundations is dated.

Investment committees make investment decisions following consultant advice.

Yet investment committees rarely meet and cannot tack quickly into shifting market winds.

The investment committee should write the rules of the investment road.

And put the investments on the back of the OCIO truck and let them drive.

FOUNDATION INVESTMENT MANAGEMENT: BREAKING THE MOULD

The investment world was shown the way to the wonders of alternative assets by David Swensen, who revolutionized the Yale endowment fund by writing the blueprint for many subsequent foundation managers. Embrace private assets and get paid for tying-up cash. Yet to emulate this strategy, size matters of it is to be cost effective.

Not all foundations are alike. The majority of foundation assets are managed by a handful of foundations, indicating that there are many smaller foundations that lack sufficient assets to tap into the alternative assets and investment strategies that help them capture higher returns and reduce overall investment risk. The same is true of Canada.

Accessing a bigger investment playing field at reasonable cost is just not available for many. Over very long periods of time, investment return short falls add up to a lot of foregone assets or lower grants than would otherwise be achieved. If private assets do yield higher returns over time, then this is a problem in search of a solution.

Before we tackle that problem, it is worth observing that the challenge of enlarging the playing field and lowering costs is not merely a function of asset size. It is also a function of governance structure and investment management execution. Let's look at the old foundation model, and then turn our attention to a better way to structure the foundation by isolating governance and investment management as two different roles. When each player sticks to its knitting, fewer stiches are dropped.

The Old Foundation Model

The old foundation asset management model features an investment committee that takes guidance from an outside

investment consultant. The investment committee is charged with making asset allocation and manager selection decisions based on recommendations from the consultant. In this model, the consultant makes recommendations not decisions, the consultant's role is purely advisory.

Allocating the decision to the investment committee on the consultant's recommendation can work well for strategic and time insensitive execution. But, when financial markets are moving quickly and decisively, the quarterly meeting schedule is not conducive to executing changes to major market movement. The consultant is not empowered to make investment decisions, nor is it expected to. The consultant cannot make the decision, and the investment committee cannot react fast enough. This can be a significant problem for maximizing investment returns.

Foundations typically have a small staff, and often the most qualified person in the investment space is a CFO who often doubles-up as the COO. It is not always the case that the CFO/COO is an experienced investment person, so often has to rely on the investment committee for support and advice. It is crucial that the committee include either current or past investment practitioners, and the committee must be both experienced and skilled in investments.

The New Foundation Model

The preferred alternative to the old model is to outsource the investment management function, and redirect the investment committee to its governance function, freeing it of investment management decisions. This means sending the assets to an Outsourced Chief Investment Officer or OCIO. And not just any OCIO, quite specifically an OCIO with a multi-asset class capability.

The benefit of the OCIO model is that it brings under one roof all of the necessary investment and financial management functions for one fixed fee. However, for this model to be effective it must be well governed and so the investment committee must change focus, change function, and often change its members.

The OCIO relationship to the foundation and its investment committee, and the defined allocation of responsibilities, are transformed from the old consultant-committee model. The OCIO takes-over significant day-to-day discretionary authority to manage the portfolio to its governing parameters, and the guidance-decision making nexus between committee and consultant is broken. The investment management function

migrates from a consultant as product provider to OCIO as solutions provider, offering better value for fees paid.

The OCIO Takes Charge

Compared to the consultant, the OCI has wide range of strategic discretion to set the asset mix, choose investment managers and which investment strategy and style to favour, and whether and how to branch-out into alternative assets. And, the OCIO also has a measure of tactical discretion. The OCIO is expected to tilt the asset allocation depending on their own views on the availability of relative value across different asset classes and markets.

The OCIO engages in a dialogue with the investment committee on their plans for portfolio changes, and this can occur outside of the regular investment committee meeting schedule when necessary. For the OCIO-foundation relationship to work effectively, the OCIO should execute on its decisions without seeking input or approval from the investment committee. This makes them responsible for outcomes, which the investment committee then monitors, and holds the OCIO to account.

There is a fine line between where an investment consultant ends and an OCIO begins, and in fact many former investment consultants have moved into the OCIO space. We have concerns about conflicts of interest in using the OCIO offerings from the investment consultants, as this is more than a mere ostensible agency issue.

So what's the advantage of the OCIO beyond discretion over asset and manager choice, and the ability to make swift portfolio adjustments? There are two crucial advantages of the OCIO relative to the investment consultant.

The first advantage is the treasury and liquidity functions, which are of crucial importance as more and more assets drift to alternative and private investments that require long lock-up periods. Setting a liquidity policy and managing cash is crucial when foundations strike-out in this direction. A good OCIO will be well resourced to provide the cash management function.

The second advantage centres on investment risk, the often ignored and evil twin of investment return. Instead of risk being managed in a discrete way by each individual manager, without consultant guidance on the amount of risk to take and monitoring total portfolio risk, the OCIO can integrate all of the risk exposures and form a reasonably clear picture on how those risks are

integrated. The OCIO will know the value of the diversification benefit, and will go out of its way to maximize it. And this simply cannot be done without a comprehensive risk calibration informing a risk management policy. This additional information improves the ability of the investment committee to execute oversight of the portfolio's performance as it will now know the return it is getting for the risk it is taking.

Resetting the Ground

The primary role of the investment committee that uses an OCIO is to set the broad strategic parameters, and not concern itself with day-to-day investment management challenges and duties. Strategy is what you do, tactics are how you do it. Investment committees are not the appropriate place to hold tactical responsibilities. Investment consultants can help you define strategy, determine asset allocation, investment beliefs and objectives.

The OCIO makes it happen. Your consultant and your OCIO need to be separate entities to avoid conflicts of interest. But the investment committee shouldn't actually do it. With the OCIO, they can give you the advice the consultant would deliver and do the day-to-day management. One stop shopping at an affordable price!

To get the full benefit from your OCIO, the foundation needs to choose a highly competent manager with deep knowledge of the capital markets and risk. If you are outsourcing every aspect of your portfolio and liquidity management, then the OCIO needs discretion to respond swiftly when financial outcomes are different than expected. You have to give them lots of field on which to play.

Look to the OCIO to determine the asset mix. Meeting aggressive return targets of 7% or more requires a meaningful allocation to alternatives to meet the return target for the appropriate amount of risk. The best contribution the investment committee can make to the investment process is to write a precise investment policy statement that sets return targets, risk tolerance and overall asset and risk allocation limits.

The OCI should have discretion to make changes to the portfolio either in the risk allocation, the choice of instrument or manager, while keeping the committee apprised and informed of any significant changes before execution with a follow-up once execution is complete.

With an OCIO you get a good, clean, look through to all risk exposure, ranging from the market allocations, to manager and strategy specific risk that (should be) uncorrelated to the market risk.

The OCIO should stress-test the entire portfolio, and determine the diversification benefit the portfolio has achieved. Having a multi-lens look into the risks across the portfolio at a both a macro level and a more granular level keeps the committee's focus on the OCIO's overall performance, and that of the assets and managers they have chosen.

With an OCIO the investment committee can focus most explicitly on investment objectives, investment intent and investment governance. The committee can ensure that the assets are being managed consistent with the investment objective. It might not be as much fun as listening to manager presentations and talking the market, but it gets better results. The OCIO knows they are being monitored, and this makes a difference to their performance.

The industry looks at OCIO selection mostly on the basis of expected performance. But the investment process is much more subtle and multi layered. How well your OCIO performs is a function of how well they work to the mandate given, and how they generate return relative to the risk they have taken. In other words, the focus has to be on the quality of the returns they generate, not the quantity of returns as this is a better way to, at least try, and separate luck from skill.

It is time for all of Canada's foundations to rethink their existing model, and think about getting their own OCIO on board.