

# The Outsour

by | **Asad Ali** and **Kenny Kelley**

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# cing Decision

Outsourced chief investment officers (OCIOs) take on investment decision making for benefit plans while also assuming fiduciary responsibility. Key considerations when choosing an OCIO include the type of firm, amount of authority to delegate and investment model.



The use of investment outsourcing has been increasing rapidly over the past 12 years, as plan sponsors seek a solution to better manage risk and enhance their investment approach. *Investment outsourcing* is the method by which plan sponsors (or other large asset owners) shift portfolio management activities to a third party that assumes fiduciary responsibility and operates with either partial or full discretion.

To do this, many plan sponsors hire an outsourced chief investment officer (OCIO). An OCIO is an advisory organization that gives plan sponsors the ability to delegate investment authority by shifting responsibility for some or all investment functions.

The types of services plan sponsors seek to delegate vary considerably, as do OCIO provider business models. Consequently, no stan-



standard OCIO definition exists, and associated nomenclature is not standardized. Although commonly referred to as OCIO, alternative designations include discretionary management, delegated solutions and implemented consulting.

OCIOs can provide the following services to plan sponsors:

- Develop investment policies
- Establish asset allocation targets and ranges
- Select investment managers
- Implement portfolio decisions
- Monitor portfolio performance and rebalancing
- Execute investment-related legal documents
- Provide operational support
- Employ risk controls.

Moreover, the OCIO solution can apply to an entire plan or portfolio or just a part.

Investment outsourcing is a large and growing market segment with nearly \$2 trillion dollars<sup>1</sup> currently managed by a variety of providers, and estimates predict the market will grow to as much as \$3 trillion or more by 2023.

### Historical Perspective

The foundations of the investment outsourcing industry were established in the 1980s. At that time, small plans without internal resources or support sought a way to obtain expert investment advice coupled with professionalized management. These plans also wanted access to attractive private market investment opportunities that had been previously unavailable due to hefty investment minimums and/or lengthy “lock-up” periods.

Lacking internal expertise, family offices (investment firms that cater to ultra-high net worth individuals), as well as smaller endowments and foundations, spurred the OCIO industry’s early growth. With supportive governance structures that offered broad discretion, these organizations sought robust investment solutions and guidance navigating an increasingly complicated investment landscape. Banks and new “boutique” advisory firms stepped in to meet this growing need for delegated management, paving the way for successive waves of OCIO providers.

Meanwhile, investment opportunities became increasingly complex. Straightforward or “traditional” stock and bond portfolios evolved when advisors began including new types of public and private market investments, such as real assets, direct lending, venture capital and infrastructure. Plan sponsors and other institutional asset owners whose primary

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business was not professional money management faced a serious knowledge gap.

The global financial crisis prompted the outsourcing industry’s most rapid expansion, reflecting the need for better risk controls and enhanced governance structures. New providers entered the marketplace, driven by growing client demand. Over the past five years alone, OCIO assets have doubled.<sup>2</sup> A report by Charles A. Skorina & Company estimates OCIO assets under management recently topped \$2.38 trillion.<sup>3</sup>

Many defined contribution (DC) and health and welfare plans have also found value in adopting the OCIO model. For example, a DC plan sponsor can hire an OCIO to design investment options tailored to its participant profile. Custom target-date funds and/or white label structures are now fast becoming commonplace in the DC market. With increased scrutiny of overall costs and fiduciary oversight, OCIOs assist DC plan sponsors by conducting regular fee benchmarking studies and assessing both the suitability and performance of sponsors’ investment menus. The DC OCIO market has an expected growth of 10.2% annualized through 2023—outpacing OCIO growth in the DB market.<sup>4</sup>

In addition, health and welfare plans struggling in the current low-yield environment have turned to OCIOs for expertise in diversifying portfolios while controlling risk and managing fluctuations in cash flows.

### Distinguishing Between Today’s Providers

As the OCIO industry has grown, so too have the number and types of providers; these now include traditional investment consultants, money management firms, OCIO-only

boutiques and larger conglomerates. Key features of each are summarized in Figure 1.

### Traditional Investment Consultant vs. an OCIO

Misunderstandings persist about the differences between a traditional investment consultant and an OCIO. Both offer (1) investment policy guidance and design, (2) dedicated resources to evaluate and monitor investment managers, and (3) reporting capabilities to assess managers and, where appropriate, total plan performance.

The key difference is “discretion.” In the traditional model, the client alone retains discretion around policy, strategy and/or implementation. In an OCIO model, decisions in each of these areas are delegated in part or in full to the OCIO provider.

For private employee benefit plans, using terminology as defined in the Employee Retirement Income

Security Act (ERISA),<sup>6</sup> discretion is also the main difference in service capacity between a 3(21) and a 3(38) fiduciary. A 3(21) *fiduciary* is anyone who provides investment recommendations to a plan sponsor for a fee. For example, when a traditional consultant recommends the plan sponsor hire a particular investment manager, the plan sponsor retains the ultimate liability for deciding whether to act on the recommendation of their 3(21) fiduciary.

When a plan sponsor gives an OCIO the authority to select investments and investment vehicles, the plan sponsor is hiring a 3(38) *fiduciary*. A 3(38) fiduciary has the power to manage, acquire or dispose of any plan assets and acknowledges its status as a fiduciary in writing. Based on the added responsibility of this decision-making capacity and the OCIO’s written acknowledgment of its role as plan fiduciary, plan sponsors receive a much greater level of relief from liability than with a traditional consultant.<sup>7</sup>

### Degrees of Discretionary Authority

Additional differences between a traditional consultant and an OCIO can be seen in the division of investment decisions (Table). Plan sponsors interested in outsourcing can choose from a “partial” or “full” discretionary solution, opting for the model that best fits their needs.

Moreover, it is not unusual for plan sponsors to start by employing a provider in a traditional 3(21) role and subsequently delegate additional (i.e., partial or full) 3(38) authority to an OCIO over time.

### Investment Models





OCIO providers commonly offer three types of investment models: complete, hybrid and custom. Figure 2 summarizes the key differences among each.

#### Complete

The complete OCIO model is usually adopted by small plans that share

**FIGURE 1**

### Comparison of Outsourced Chief Investment Officer (OCIO) Providers

	Investment Consultants	Money Management Firms	OCIO-Only Boutiques	Conglomerates
<i>What They Do</i>	 <ul style="list-style-type: none"> <li>• Provide advice</li> <li>• Research</li> </ul>	 <ul style="list-style-type: none"> <li>• Manage funds</li> <li>• Research</li> </ul>	 <ul style="list-style-type: none"> <li>• Focus on OCIO</li> <li>• Manage portfolios</li> </ul>	 <ul style="list-style-type: none"> <li>• A little bit of everything</li> </ul>
<i>What They Don't Do</i>	<ul style="list-style-type: none"> <li>• Custody</li> <li>• Administration</li> </ul>	<ul style="list-style-type: none"> <li>• Administration</li> </ul>	<ul style="list-style-type: none"> <li>• Custody</li> <li>• Administration</li> </ul>	<ul style="list-style-type: none"> <li>• OCIO as an add-on service</li> </ul>

TABLE

**Who Has Discretionary Authority?**

	<b>Traditional Consultant</b>	<b>Partial Discretion Outsourced Chief Investment Officer (OCIO)</b>	<b>Full Discretion OCIO</b>
<b>Determining investment policy</b>	Trustees	Trustees	OCIO
<b>Establishing asset allocation</b>	Trustees	Trustees	OCIO
<b>Appointing, retaining and removing investment managers</b>	Trustees	OCIO	OCIO
<b>Producing total plan reporting</b>	Consultant	Consultant/OCIO	Consultant/OCIO
<b>Delivering trustee education</b>	Consultant	Consultant/OCIO	Consultant/OCIO

one or more common objectives (e.g., a target rate of return). The OCIO manages a single, commingled fund-of-funds portfolio in which these plans invest and may even include custody and administrative services. Advantages include simplicity, an audited performance record and relief from nearly all responsibility. Disadvantages can include opaque underlying fees, lack of asset allocation and implementation flexibility, potential conflicts of interest and liquidity limitations.

**Hybrid**

The hybrid OCIO model pools client monies within the same asset class, creating multiple commingled funds. For instance, all clients may own the same fixed income “trust” or “sleeve” in varying amounts based on their individual asset allocation. Clients can maintain input by choosing what sleeve fits best within a portfolio, thus allowing the structure to be built around legacy assets. Like a complete solution, conflicts

of interest may exist as the OCIO seeks preferential relationships with lower cost underlying managers or manages its own proprietary investment vehicles. Other potential weaknesses of the hybrid model include a lack of portability and limited flexibility.

**Custom**

A custom (or open architecture) model is a fully tailored solution for each client. A custom model is usually fully transparent concerning strategy, managers and holdings. One drawback may be a slightly higher overall cost, which is balanced by a risk/return profile designed expressly for a client’s specific circumstances. In addition, most OCIO providers negotiate terms and fees with investment managers based on total assets under management, giving their plan sponsor clients access to fee reductions and/or limited investment opportunities otherwise precluded by minimum placement restrictions.

According to Cerrulli Associates,<sup>8</sup> approximately 81% of plan sponsors or asset owners use an open-architecture platform, and just 7% are using a complete or one-size-fits-all solution. Institutional investors and search consultants generally prefer open-architecture platforms because of conflict-of-interest concerns inherent in the complete and hybrid structures.

**Why Consider an OCIO**

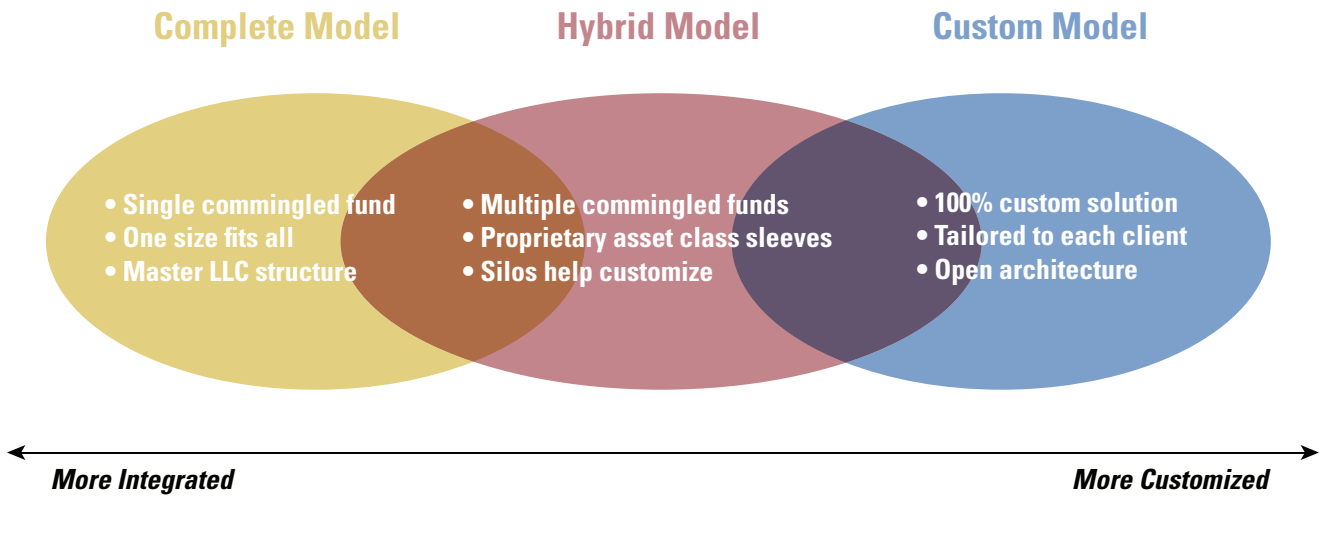
Top reasons plan sponsors are looking to outsource investment responsibility are (1) a lack of internal resources, (2) better risk management and (3) additional fiduciary oversight.<sup>9</sup>

**Lack of Internal Resources**

Boards, investment committees and even financial officers may not have the requisite skill and knowledge about an ever-changing investment world. In addition, most boards or committees typically meet between two and four times per year and, as a result, spend less than

FIGURE 2

**Outsourced Chief Investment Officer (OCIO) Investment Models**



one workweek per year on investment issues. Ceding greater levels of discretion to an OCIO provider allows the sponsor and its staff, board and/or investment committee to focus on strategic, organizational-level decisions while freeing themselves of the burden of becoming investment experts.

OCIOs bring plan sponsors fiduciary relief across the decision-making spectrum and throughout the investment lifecycle. For example, by assuming the tasks of manager selection, retention and termination, an OCIO can expedite and streamline the process, reducing implementation delays or errors. OCIOs also add value in contract review and negotiation, particularly with complex investments, and provide detailed recordkeeping and operational support.

Demonstrating a prudent process is a legal imperative for fiduciaries, and the single most effective means of meeting this standard is through detailed documentation. Good record keeping captures the key facts of proper process. An OCIO not only maintains an internal book of record but has redundant procedures to ensure this aspect of plan management is effective.

**Better Risk Management**

An OCIO’s expertise in capital markets and investment strategy may yield faster and better-informed outcomes for plan sponsors. For example, if a manager suffers a major setback (such as a key employee departure), an effective OCIO will have

a contingency plan in place to immediately remove and replace the strategy. Addressing a problematic investment in a traditional model may take far longer, since traditional consultants do not have the discretion to act without formal approval.

OCIOs can also help control risk through timely portfolio rebalancing. To formalize the process and eliminate any bias, many OCIO’s set rebalancing “triggers” at time intervals

**takeaways**

- *Investment outsourcing* is the method by which plan sponsors (or other large asset owners) shift portfolio management activities to a third party that assumes fiduciary responsibility and operates with either partial or full discretion to make investment decisions.
- Outsourced chief investment officers (OCIOs) can provide services including developing investment policies, selecting investment managers and monitoring portfolio performance.
- Plan sponsors can choose from an OCIO that has full or partial discretion.
- Reasons that plans might outsource investment responsibility to an OCIO include lack of internal resources, a need for better risk management and fiduciary oversight.
- Outsourcing investment responsibility may include slightly higher cost, although this could be made up through lower fee “bundled” pricing arrangement with investment managers

(quarterly or semiannually, for example) or use specialized rebalancing managers. When a portfolio's asset allocation deviates from its strategic targets by certain, predetermined percentages, an OCIO can act to rebalance risk effectively.

### **Additional Fiduciary Oversight**

ERISA places many responsibilities on plan fiduciaries. Among them is the responsibility to invest plan assets in the same manner as a reasonably prudent expert. Moreover, ERISA generally prohibits any contractual abrogation of fiduciary duties, although they may be delegated as in the case of a 3(38) fiduciary (e.g., an OCIO).

Under ERISA Section 405, if a plan sponsor correctly appoints an OCIO, the plan sponsor has no responsibility to manage the assets that are under the OCIO's control and has no co-fiduciary liability unless the sponsor knowingly participated in a fiduciary breach.<sup>10</sup> ERISA Sections 403, 405 and 410 are written in a manner that almost encourages plan trustees to delegate investment decisions to investment managers.<sup>11</sup> A well-managed OCIO functioning cohesively can relieve fiduciaries of potential liability in navigating a complex investment world.

Most traditional consulting arrangements do not offer Section 405 protections. Traditional consultants serve only in a 3(21) capacity and make recommendations, with the plan sponsors retaining authority and thus, liability, for implementation of those recommendations. When an OCIO has full discretion to select an investment manager, the OCIO owns that decision and is accountable if the decision is not fiduciarily sound. This delegation gives plan sponsors protection when complex investment strategies are implemented.

### **Additional Considerations**

If a plan sponsor (or asset owner) has delegated investment decision making to an OCIO, trustees are not allowed to ignore plan assets and investment strategy. Rather, they maintain a duty to monitor overall investment performance and the reasonableness of fees on a periodic basis.<sup>12</sup> Trustees or investment committee members would be wise to faithfully review all reports, understand the plan's investment architecture and clarify the trustee duty to monitor (with legal counsel).

Given additional back-office workload and the responsibility of serving as a 3(38) fiduciary, an OCIO service could come with a higher cost than a traditional 3(21) consulting relationship. Still, an OCIO firm may be able to negotiate

## **bios**



**Asad Ali** is a firm principal and managing senior consultant at Alan Biller and Associates in Menlo Park, California. He consults to defined benefit, defined contribution and health and welfare plans. He assists clients with all types of projects, including asset allocation and liability studies, all-in-fee assessments, plan investment structure reviews, manager searches and investment policy statements. Ali holds a B.A. degree in economics from the University of Connecticut and an M.B.A. degree from the Isenberg School of Management at the University of Massachusetts Amherst. He is a decorated veteran who served in the U.S. Air Force.



**Kenny Kelley** is an attorney at Ryan, Rapp & Underwood, P.L.C., where he focuses his practice on employee benefits, representing public and private benefit plans. He assists private benefit plan clients, including multiemployer defined benefit, defined contribution and welfare plans, in drafting and amending plan documents, trust agreements and participant notices, negotiating contracts with service providers and making appeals determinations. On the public side, Kelley works with local boards that participate in Arizona's Public Safety Personnel Retirement System in performing their obligations under the state statute. He also assists with the review of investment documents and conflicts issues for public pension funds. Kelly holds a J.D. degree from California Western School of Law.

lower manager fees through bundling arrangements, which may offset the added cost or potentially reduce the overall investment expense for a plan.

Another consideration is whether an OCIO has an arrangement with underlying managers to trade through or utilize affiliated broker-dealers. These arrangements can give rise to prohibited transaction issues that trustees should be aware of. Finding an OCIO that is independent is therefore crucial and can help avoid a conflict of interest.

## Selecting a Provider

There are many issues for plan sponsors to consider when deciding whether an OCIO model can be beneficial. First, sponsors should review the plan's investment policy statement and all advisory agreements to understand the assignment of responsibility and delegation, if any, of decision-making authority. Many trustees are surprised to learn they have a fiduciary duty to oversee a greater number of investment functions than they were aware of. Shifting more of this obligation to an OCIO can make sense.<sup>13</sup>

Once a board or investment committee has decided that an OCIO can better fulfill the sponsor's needs by achieving plan investment objectives, there are several key considerations including the following.

- The agreement should designate the OCIO as an ERISA 3(38) fiduciary.
- The OCIO provider should accept fiduciary responsibility in writing for all plan investments.
- Roles and responsibilities for each party should be clearly defined in the agreement.
- Potential conflicts of interest should be identified and OCIO independence verified by confirming that the OCIO's sole source of compensation is directly from the plan.
- Operational competencies should be evaluated, as an OCIO's administrative and back-office capabilities must surpass the resources available in traditional advisory relationships.

## Conclusion

In the current environment in which fiduciary pressures are building, tight budgets are constraining resources and decisions are getting harder, plan sponsors and asset owners may want to consider getting both assistance and relief from an OCIO provider. **■**

## Endnotes

1. *2020 Outsourced-Chief Investment Officer Survey*, Asset International-Chief Investment Officer, March 16, 2020.
2. *Ibid*; *2016 Outsourced-Chief Investment Officer Survey*, Asset International-Chief Investment Officer, February 24, 2016.
3. *Skorina's 2019 OCIO Report*, Charles Skorina & Company.
4. "U.S. Outsourced Chief Investment Officer Function 2019." *The Cerulli Report*.
5. *2020 Outsourced-Chief Investment Officer Survey*. Asset International-Chief Investment Officer, March 16, 2020.
6. 29 USC §1002, 29 CFR §2510.3-21 and 29 CFR §2510.3-38.
7. *Perez v. WPN Corporation*, 2017 WL 2461452 (W.D. Penn. 2017). (The court granted the defendant trustees' motion to dismiss for failure to invest and co-fiduciary liability because "once Defendants appointed investment managers they [were] entitled to the safe harbor protection.")
8. *2019 OCIO Providers Survey*, Cerulli Associates, November 2019.
9. *2020 Outsourced-Chief Investment Officer Survey*, Asset International-Chief Investment Officer, March 16, 2020.
10. 29 USC §1105(d)(1).
11. *Lowen v. Tower Asset Management, Inc.* 829 F.3d 1209, 1219 (2nd Cir. 1987). ("The plain intent of this statutory structure is to allow plan trustees to delegate investment authority to a professional advisor who then becomes a fiduciary with a duty of care and duty of loyalty to the plan while the trustees' legal responsibilities regarding the wisdom of investments are correspondingly reduced.")
12. See *Tibble v. Edison Int'l et al.*, 135 S.Ct. 1823, 575 U.S. 523 (2015).
13. In a recent survey, one in four plan sponsors incorrectly believed it had completely delegated the responsibility for their plan's investments. "2019 Defined Contribution Plan Sponsor Survey Findings," J.P. Morgan Distribution Services, Inc. October 2019.