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Embracing an OCIO Partnership

An aging bull market, uncertain interest rates and a volatile global economy pose a particularly difficult set of challenges for today's institutional investors, even as they cope with heightened expectations around risk management, tight budgets and regulatory changes.

Such factors are driving more chief financial officers and investment committees to look externally for help navigating these challenges from an outsourced CIO. In January, Cerulli Associates estimated that the compound annual growth of U.S. OCIO assets under management would reach more than 8.1% through 2023.

State Street Global Advisors, the seventh-largest provider of OCIO services, has seen that increased demand from institutional asset owners who are looking for enhanced governance and fiduciary oversight, as well as more efficient investment decision-making. They're also all typically looking for cost savings, according to Natasha Dayaramani, managing director and global head of portfolio strategies with State Street's OCIO team.

"The cost of having a team that can really look at strategic and tactical asset allocation, implementation and trading, investment and operational due diligence, compliance, legal, even HR can all be saved when moving to an OCIO model," Dayaramani said.

Those savings are easier to see as OCIOs move to unbundled pricing and more transparency around their cost. That way, clients understand when they're paying for specific projects, but they can also see the lower fees that OCIOs are able to achieve through scale.

As more institutions look to move to an OCIO model, they're also demanding more from their OCIOs, and OCIOs are rising to meet the challenge.

SOARING INTEREST ACROSS THE BOARD

While smaller institutions have historically been more likely to use an OCIO model, larger investors including pensions plans, endowments and defined contribution plans are increasingly finding that the model makes sense for them as well.

In addition to cost savings and market uncertainty, institutional investors often have specific reasons for moving to an OCIO model. A CIO might retire, for example, or a recent merger could mean that one institution suddenly finds itself with several distinct pools of assets, all with different funding statuses and investment objectives. Large, multi-geographical clients turn to OCIOs to help navigate the complex regulatory funding and governance structures across different plans around the globe.

Smaller institutions, such as registered investment advisers or family offices, on the other hand, may need more partnership around risk and governance or in trustee training. Pension plans of all sizes are looking for advice on the best course of action, whether that's hibernation, or reducing or terminating their pension liability.

"As we always say to clients, the best testament to an effective OCIO mandate is putting ourselves out of business, which means they've reached a well-funded status, at which point they may decide to annuitize parts of the plan or terminate. " Dayaramani said.

THE AGILITY ADVANTAGE

Regardless of the reason behind a move to an OCIO model, institutional investors benefit from the ability of OCIOs to be nimble, particularly in times of higher volatility, according to Dayaramani.

She cited pension fund glidepaths to illustrate the value an OCIO offers. "When a plan hits a de-risking trigger, the OCIO provider can quickly reallocate the portfolio, locking in funded status gains," she said. "Plan sponsors often have to go to boards or committees, which increases the potential to lose funded status improvement or even have committee members debating established glidepaths." For larger plans, the ability to manage liquidity and transaction costs moving from return seeking growth assets, into long duration fixed income (particularly long corporate bonds) is critical in order to shift to the target asset allocation and desired risk profile.

At State Street, fiduciary responsibility is central to all strategic and investment decisions made to navigate the shifting investment environment.

OCIO providers with experience in tactical asset allocation can provide enhanced risk management in times of stress by underweighting less attractive asset classes or implement a portfolio hedge, often synthetically, to mitigate risk in a cost efficient and objective manner.

When making changes to a particular portfolio, the focus of State Street OCIO is always fiduciary responsibility and whether the strategic allocation and portfolio construction make sense for the environment ahead.

"We believe in positioning the portfolio around the plan's strategic benchmark to provide an additional source of alpha," Dayaramani said. "This often complements alpha from active management strategies within the portfolio and provides a potential source of risk management, reducing exposure to less desirable asset classes. The positioning around a client strategic policy benchmark is designed with the three- to 12-month horizon in view. In each case, we are mindful of transaction cost and the potential benefits."

Another benefit of an outsourced CIO, particularly for institutional asset owners that don't have adequate staff to oversee a large asset pool such as a pension fund or endowment, is the ability to free up personnel to deal with other issues such as meeting regulatory requirements and making strategy decisions. Clients who use an OCIO essentially expand the breadth and expertise of their team and gain a third-party to help oversee outside service providers.

Institutions that aren't ready to fully outsource might start by using an OCIO for specific asset sleeves, if they have limited staff or expertise in a specific area, such as alternative allocations or a mandate to incorporate ESG principles. Whether a firm has outsourced their entire plan or only a sleeve, State Street aims to have clients think of the relationship as a true partnership that allows them to focus on their strategic initiatives, Dayaramani said.

As the OCIO model has become a more widely accepted strategy, institutional investors have also expanded the role that the OCIO plays, often shifting from an advisory or semi-delegated model to a discretionary model. This allows the OCIO to take on greater fiduciary responsibilities with respect to manager selection and ability to hire and fire underlying investment managers. Ceding greater levels of discretion to the OCIO provider enables the sponsor, their staff and committee to focus on larger strategic decisions such as asset allocation and near-term and long-term objectives for the plan. It also allows the sponsor to focus valuable resources on managing their core business, which is the ultimate overarching benefit of any company outsourcing initiative.

"For us, success comes when the client can feel comfortable picking up the phone and handing off projects, knowing they will be completed as if we were an extension of staff, which is really our client-executive model, and knowing that they will be done at no extra cost," she said. •

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