Pensions&Investments

2011 Investment Outsourcing Round Table Transcript

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An open letter from Joseph Gelly,
Managing Director, Investment Outsourcing, US Institutional

What's the single most important quality in an investment outsourcing relationship?

You are.

This may sound like marketing fluff. Don't let it. The relationship shouldn't revolve around the service provider's existing products or business goals. It should revolve around you and your needs. Be clear about what you want for your investment program and accept nothing less. Demand attention and a thought-out, customized solution instead of the off-the-shelf, product-driven services so commonly seen in the market.

Russell's been focusing on helping institutional investors meet their objectives for many decades. Your goals are still our focus. What risk are you trying to mitigate? What funding level are you trying to hit? How is your investment program impacting your organization's financial statements? How much control do you want to maintain? And how much of the burden of responsibility do you want to share? Tell us.

We think you need an outsourcing provider who considers your problem a unique one, then works to solve it with a flexible, customized, strategic approach—one built around transparency and open architecture. To deliver this, we think you need a partner who delivers industry-leading advice *and* the ability to execute…with the track record to back it up.

But that's just us talking. We want to hear your side.

For institutional investors like you, the *old* way of managing investments no longer works. So we've adjusted our approach, focusing more on delivering customized solutions, taking on day-to-day management of your investments, and accepting increased fiduciary responsibility. The result is a strategic partner who is actively engaged in your success and acts as an extension of your staff.

But one thing hasn't changed. You're still at the center of our attention. And before we can do anything to help improve your situation, *you* need to talk and *we* need to listen. So I'd personally like to hear from you. That's why I'm listing my direct phone number and email at the end of this letter. My pledge is that if you'll call or email, I'll pay attention and personally respond.

At Russell, you have a team that cares about what's important to you.

Sincerely,

Joe

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PENSIONS & INVESTMENTS

2011 Investment Outsourcing Round Table

Investment outsourcing has become one of the fastest-growing parts of money management. On June 1, *Pensions & Investments* convened a round table to discuss.

Pensions & Investments: Kevin, what are the key reasons pension funds, endowments, foundations and even some defined contribution plans are outsourcing the investment management of their assets?

Kevin Quirk: I think maybe first and foremost, it's important to understand that from where we sit, outsourcing is really part of a broader trend that's going on in the industry —the movement toward what we call solutions. Albeit (that's) a very broad concept and thrown around the industry a lot, but if you look across market segments, if you look across the industry at large, what you see, either in packaged form or in more customized form, there's a movement toward solutions by investors.

So specifically what I mean by that, you'll see things like investment outsourcing. (That's) becoming more and more prominent in the U.S. institutional marketplace. We've seen it in places like the fiduciary market in Holland.

What's driving it? There's a couple of big things, in our opinion. The first is probably the fact that the capital market conditions have been as challenging as they've ever been. If you look back over the last 10 years or so, I think if you were to say to an investor that in your lifetime you would look back over 10 years, look at your portfolio and realize that it was either flat or down for that 10-year period, it would probably be hard to imagine, especially when we were sitting in such a wonderful environment in the 1980s and 1990s.

So, clearly, the experience of the investor in the last decade has been a big driver for why people are moving (to) — at least one of the big drivers why people are thinking about — solutions and more specifically outsourcing.

A second big driver that we see is resources. If you look at the resources that institutional investors have at their disposal, you know, generally there's been a downward trend in resources.

P&I: By resources, you mean people?

Mr. Quirk: People. Budgets. Just the ability to put stuff against

Participating were:

Christopher Delaney, associate treasurer-finance and administration at Gettysburg College, Gettysburg, Pa.;

Jay Gepfert, senior consultant at New England Retirement Consultants LLC, Boston, which evaluates investment outsourcers for institutional investors;

Jonathan J. Hirtle, CEO of Hirtle, Callaghan & Co., West Conshohocken, Pa., which manages $20 billion in portfolio outsourcing strategies;

George K. Mateyo II, senior director of investments at the Cleveland Clinic Foundation, Cleveland;

R. Bruce Myers, managing director of consultant Cambridge Associates LLC. Boston, which manages $105 billion in outsourced strategies; and

Kevin P. Quirk, founding partner and principal of Casey, Quirk & Associates LLC, Darien, Conn., a consultant to money managers;

Nancy K. Webman, editor of P&I, moderated.

the problem, the investment problem. We see staffs that have been cut, we see budgets that have been cut, and so it's becoming more and more difficult — especially for institutional investors. So resources is a big issue.

A third big trend is demand for alternatives. Alternatives has been … an area where we've seen a lot of growth in the last … 10 years, and it's a much more complex landscape for investors to navigate. In many cases, it's difficult to get access, and so outsourcing types of arrangements can create a vehicle or a situation or a platform, I should say, that allow investors to get better access into alternatives.

So these are two or three of what we deem to be the bigger drivers of growth in the outsourcing business.

Jonathan Hirtle: I would just emphasize, I agree with everything that Kevin said. The solution focus is a function of complexity …

In the 30 years I've been in the business, complexity has really skyrocketed and governance is pretty much the same. If you look at a quarterly meeting, you walk in, it's really sort of the same people who were there 30 years ago, except these are their kids. So their fathers were on that committee 30 years ago. They're asking the same questions … and yet the challenge is dramatically more complex: Just the number of alternatives; the tools that are available in the marketplace.

So the complexity to me is — we use health care as an analogy a lot, and you know, what you've seen is the development of the medical center. … in health care, the assemblage of the solution is much more valuable to you as a consumer than the next pill that comes out of Merck.

So it's not that next creative product that is so interesting to you, it's going to … one of these great medical centers and having all of those products reviewed and assembled into something that works for you. …

I'd just take a step back and say that it's really driven by the complexity. And by the way, the complexity is not going to stop. Complexity is a function of globalization. More people in the free market with great ideas, coming up in new interesting products.

So if anything, it's going to just get more and more complex. And then the other thing is … that complexity implies that to have a fully staffed investment department is a bigger challenge than it used to be. So right when you're cutting staff, you actually need to be adding staff. …

So it's hard. It takes a lot of money to amortize all that diverse capability. So I think those would be my amplifications of what Kevin said.

Jay Gepfert: The only other comment I would make is that traditionally people have talked about outsourcing — and Kevin alluded to it — in the (endowment and foundation) and pension side of things. And I think a forbearer of what we're beginning to see, where there's tremendous assets, is on the DC side. It's actually starting fairly small, and what it's being driven by is the request by fiduciaries to mitigate or reduce fiduciary risk as much as they possibly can.

And that's with multiple-employer plans right now. It started very small. Multiple-employer plans have been around for 20-plus years for the 401(k) and the 403(b) market. But because of a decision by the Supreme Court in 2008, it made it so that fiduciary risk is substantially higher now, because now individual participants can sue.

And so we've already started to see this outgrowth of three or four independent multiple-employer plans trying to begin to gobble up small plans. Because the fiduciaries just sit there and say "Hey, listen, I don't have the time, I don't have the expertise, and that's not a healthy combination of no time, no expertise, but my personal assets are at jeopardy."

So that's an area we're beginning to see outside of the traditional pension and E&F marketplaces.

Bruce Myers: My footnote to the conversation would be to point out the difference we see between the pension world and the nonprofit world. While the pension world is frequently presided over — not 100%, but frequently — by corporate staff or state employees, the endowment and foundation world relies on volunteer investment committee members.

And we've talked a lot about fiduciary fatigue due to the market complexity that Kevin noted, and also, the market turbulence —a lot of these committees are used to meeting quarterly and are finding the demands for the job just a whole lot harder than it was when their fathers were on the board ...

Mr. Quirk: I'd just add one more point in listening on this. The other thing that I think is interesting about this part of the industry is that while it's still in a very early stage. there's been a tremendous amount of growth (in it), especially in the last couple of years. A part of it has been the dialogue and just the crystallization of the idea of investment outsourcing. And I would say that one of the big reasons for that is firms like Jon's … firms that have gotten in the business to expressly be in the outsourcing business, that's why they exist. That's what they've been doing at Jon's firm and a few others have been doing for quite some time.

But because they've created business models that focus entirely on the concept of investment outsourcing, I think that's created a lot of dialogue around the idea and really has been a bit of a game changer.

So while some of these firms have been around for a long time, it really seems to me in the last three or four years, and I think all of us have picked up on this, you're seeing a lot more conversation about it.

For example, I get a lot more phone calls today from small / midsize institutional investors who ask me: "How do I even begin to think about this?" But it's interesting that a lot of people have been talking about it and have been defining it in a lot clearer terms, and I think an important part of the credit goes to the firms who have actually focused their business model entirely on this.

Now they're not the only firms competing for this business. Not by a long shot. But the fact that they exist as a sole business model I think is interesting and says something about the importance of the business.

George Mateyo: Yeah. I think it's interesting on that point. Not that I'm here to talk about the industry perspective, but I would venture to guess, Jon, that 10 years ago you had to really explain what outsourcing is or what it wasn't or kind of put it in a box and define it in some way.

It seems more and more today that you don't have to make those introductory remarks. … It has become more commonplace and there seems to be some commonality around what it is.

Mr. Hirtle: I think it was Billy Bob Thornton that said the average overnight success takes 20 years. So it's been this sort of long battle of repeating ourselves. But it is absolutely different, George, in the sense that early on we'd go through the whole presentation and at the end, you know, the committee members would say, "So what is your favorite stock?" And I'd say, "Let me try this again." And we realized we weren't telling the story very well.

So … now, lots of people are herding people into the church and you've got to pick a pew. It's a different discussion than it used to be.

Mr. Gepfert: It's interesting, because we're not an outsourcing firm. We help organizations find outsourcing …

You were talking about 10 years ago you could barely mention it and people understand what it is. Well, you know, there's — we track now somewhere between 25 and 30 (firms) — and it seems as if it's growing almost on a daily basis …

So … our observation is it has increased faster on a percentage basis than the actual assets, which says the industry is ahead and it's waiting for more of the investors to move in to that solution.

Mr. Mateyo: Are you counting the traditional consultants in that 25 to 30 number?

Mr. Gepfert: No.

Mr. Mateyo: These are just pure outsourcers?

Mr. Gepfert: If it's like a Cambridge who does both, that would be inclusive in that. But this would be, you know, some form of an outsourcing solution and there's a large spectrum of discretion that's given you. But it's growing every day it seems like.

Chris Delaney: Using our institution as an example, all the points came up that you sort of brought up. I think for us, it was (that) we were at a moment where some of the board members that were on the investment committee were moving on. New members were coming on. Different capabilities. Different level of resources — meaning time — that they could dedicate to this.

And at that point, they wanted to basically go out and look at the different models of investment outsourcing, funds of funds, you know, sort of this matrix that we do with Cambridge right now, where we have a blend that we came up with.

But I think at the end of the day, the decision was, "How do we meet our fiduciary responsibilities most effectively." For a small endowment like Gettysburg, around $200 million, it wasn't prudent for us to bring in the staff; we felt that it was the most cost-effective way of getting the capabilities and the resources that we need by turning to outsourcing.

But, again, all of the reasons that you brought up sort of were woven within that. When we were doing this, we were looking at environments becoming more complicated. We had a complicated portfolio where our private investments were direct investments. We wanted to be able to explore doing direct investments and hedge funds. We knew we were going to have a need for certain capabilities and some sort of outsourcing, and picking, cherry-picking sort of, what services we needed seemed to be the best model for us.

P&I: So the term "cherry-picking," that means that you didn't outsource all of your investment management?

Mr. Delaney: The way we did it, we basically had some discussions around it, namely the different models, and then we literally started with our investment policy statement, and lined up the different responsibilities the board, the staff and the consultant traditionally manage.

For instance, tactical decision-making: We decided that we wanted to give the adviser discretion to make tactical decisions within the approved policy guidelines. Anything that went beyond the policy, that would have to be approved by the board.

Liquid investments vs. illiquid investments — again, pretty much all discretion was given to the manager, the adviser, to make choices for liquid investments, but when we turn to illiquid investments, it had a tail that could go from six to 15 years. The committee wanted to have conversations about liquidity, understand the context of what that liquidity would mean not just for the endowment, but for the balance of the college going forward.

So, again, we sort of went through those different areas and presented this is where we think the board would be comfortable with their responsibility, primarily policy-related issues; here's where we think the staff would be complementing the investment adviser; and these are the areas of discretion and non-discretion that the investment adviser would have.

So, again, it wasn't complete outsourcing. It was sort of putting constraints around the different areas of responsibilities in managing a portfolio.

Mr. Hirtle: Which I think is also similar to if you hired an internal CIO, and the person showed up, and you didn't really know him that well. You would say, "Well, to start with, we're going to give you this discretion, and then we're going to work with you and see how that works, and maybe we're going to dial up your level of discretion over time as we get to know you better" and so forth.

So I think … that can be very specific to the relationship.

P&I: George, can you talk a little bit about why Cleveland Clinic outsourced?

Mr. Mateyo: Sure. I think it's pretty well encapsulated in a lot of the discussion that we already had and some of the points that were made, but for us, it was probably the experience of the market over the last 10 or so years that drove that (decision).

It was committee members not really wanting to entertain the beauty contest of interviewing managers all the time and realizing that was a pretty ineffective approach to picking managers — where you spend 15, 20 minutes really interviewing a manager that you're about to award X millions of dollars to. Did it really lead to the best outcomes? …

I think there were some discussions around the idea of building in-house vs. hiring a third-party firm, and the cost involved with actually building out a team of 15, 20 people … and what that meant.

Maybe if they associated risk with that — if you build a team will they stay — was maybe a consideration also.

And I think more than anything, and Chris talked on this a little bit as well, just recognizing the linkage between the investment portfolio and the balance sheet has become so critical, to our institution anyway, that we felt we needed to put significant resources on it and make sure we managed it appropriately.

So I think it was all those kind of events driving it at the same time.

My role is kind of new in the sense that it was added alongside the fact that an outsourced firm was hired. We wanted some internal redundancies to some extent, where our office internally is running somewhat parallel with the outsourcer and involved in certain reviews of managers, tactical decisions for example.

We like to give the outsourcer a fair amount of discretion; we don't like to obstruct their process. But we like to be an advocate — and be a real internal set of eyes, if you will — for the institution, while also working in tandem with the outsourcer on things.

So it's a bit of a hybrid to some extent, but that's how it's been set up and those are some of the drivers that got us into that position.

Mr. Delaney: Well, one of the items that wasn't mentioned and one of the considerations that we had was making sure that we selected an adviser that had access to what we would consider best-in-class managers.

So there was a scale to the outsource provider. …Some committees use their board members to sort of open doors into … compelling investments. Turning to a consultant like this, we wanted to make sure that they had a deep base of having views to take.

P&I: Let's go to another question: When does outsourcing not make sense? Jon, maybe we'll start with you this time.

Mr. Hirtle: I actually thought about this and I was trying to think when — because once again, you have to figure out a way to address the complexity. And most funds don't have a good way to do that.

So — large assets, you've got to have a lot of assets so you can amortize your own staff. And I would make the case that that's not enough.

I would also make a second requirement, and that is that you have to live in a major metropolitan area, because you've got to have access to the talent, and even if you have a lot of assets, you may not be able to get the talent to come and stay if you're in an area where they don't want to live. …

And then the third thing I would say is, very idiosyncratic circumstances … so you really need internal staff to respond back and forth. … I can't actually give you an example what I mean by that, I just mean the more idiosyncratic it is, the more likely internal staff would be appealing, as opposed to someone who was, you know, very close, but not internal.

But, you know, I would go back to this notion of this medical center. When do you not need the expertise ofan expert center? I thought George's comment was an interesting one — where you have someone internal who can maybe, you know, really enhance that liaison function without having to have 20 people on staff. So you might have a small staff internally, even if you had a lot of assets, like Cleveland Clinic does. So that's an interesting hybrid.

So it's not —as George called it, it's not outsourced completely,. You're really relying on an outsource firm for depth of staff and capability, but you have a full-time professional on staff to kind of make it hum for you. So I think that's an interesting development.

And I would just make an aside: This is what happens when developing industry segments — you're seeing the market respond — and now we have a new version of outsourcing. You have outsourcing, you have internal and now we have a hybrid system.

So that's the mark of an evolving market niche. When we think about what's going to happen to this segment, it's sort of business school stuff. … There's going to be a lot of entrants. There's going to be consolidation. All the stuff that every developing niche goes through.

But anyway, so those are my three ideas: large assets, major metropolitan area, idiosyncratic fact pattern.

P&I: Kevin?

Mr. Quirk: … Taking away the idea that you've got kind of large investors that have big internal staffs that probably are not heavily reliant on external advisers to do their job, you have everybody else, right? And everybody else for the most part is using some kind of external adviser to help them.

And then it comes down to what's the construct of that advice, in what kind of arrangement are we going to establish things. I tend to think about this thing in a very simple way, which is incentive alignments. What kind of incentive alignment and what kind of skill set do you want your external adviser to be arranged around.

To my mind, you can boil that down to kind of two simple things. One, you can have the classic consulting arrangement. The classic consulting arrangement is one where it's oriented around very much an advisory type of relationship, typically the economics for the consultant are structured in some type of retainer fee.

But at the end of the day, all of the decision making is on the committee or the investments people within the institution. And so that relationship is one where the consultant arrives and says, "Here are your options, you work with us and tell us what you want to do."

Mr. Hirtle: And specifically, Kevin, I mean, if you're not a registered investment adviser, the consultant's not a co-fiduciary. So it is a very different role.

Mr. Quirk: Absolutely. Absolutely. And then there's the second option, where the incentive alignments are much more clearly linked to decision making and performance, especially. And to my mind, the question of when does it make sense or when does it not make sense really comes back to the investment committee, the board, the investment staff, thinking about it in those terms. What kind of arrangement do they want to have with your adviser? Do they want to have an arrangement where they're very hands on and they're very involved in all the elements of decision making, or do they want to have an arrangement where they're really outsourcing a lot of the key decision making.

It doesn't mean in that outsourcing situation … you don't establish clear guidelines, you're not involved in doing all the important things that set the strategic path for what the portfolio will do. But you're going to align the incentives in a way that the outsourcer is really going to make tactical decisions; it's going to make decisions with regards to direct vs. fund-of-funds type of structures; it's going to make decisions with regard to overlays and other tactical decisions. These sorts of things are going to be in the hands of the outsourcer.

And I think for those committees … and boards, I think it comes down to their desire and comfort level with those two basic structures in figuring out what makes better sense for them.

Mr. Mateyo: I think it's even challenging at the committee level, too, in the sense that you want to have, ideally, committee members that have a global perspective about the capital markets, right? It's nice probably to have titans of the industry that dominate private equity, for example, or bond kings or something of that sort.

But more and more it seems like from our perspective, having people who have a real appreciation for the global markets and the complexity of those markets means the committee is being burdened in a way that they haven't been before.

So I think that's a big challenge for them. I guess we're kind of going back to the first question a little bit, but I think that's a real tug too.

Mr. Hirtle: I wanted to clarify … when I said "large assets," when we started in the business 23 years ago, we thought we would never have an account over $1 billion. I mean, it was just sort of our rule of thumb. And today we have accounts that are approaching — our largest account is about $2.5 billion. And we saw, what is it, City of San Diego outsourcing $7 billion or whatever it was.

So I do think what "large" is is being redefined. And so really what I think you have to (ask) is, How many assets do I have? What size of assets does it take to amortize a staff, a big staff? And I was going to say a staff of 20, but, you know, maybe with George's model, you could modify that and say you don't really need a staff of 20, you need some internal people augmented by an outsourced system and some sort of a hybrid. …

I know I could not run a program by myself. You need the staff, you need the expertise in alternatives, in overlays, in manager search, in strategy. You know, all the areas — all the quantitative work that you have to do to come up with strong opinions. So it takes a lot of assets today to amortize a full staff.

Mr. Gepfert: … You talk about additional complexity and all those types of things. We have organizations we talk to that, frankly, are so intimidated by the complexity, whether they do it or someone else does it, that they go to the other end of the spectrum, which is, "Hey, we're going to make this thing as simple as we possibly can."

So the answer to the question is maybe those organizations that have said "Hey, we don't want to get heavy into the alternatives; we don't want to try to do active manager selection; we want to go total passive. We want to have a very small percent in alternatives." That may be a function of size or sophistication or expertise or whatever else, but that may be — that's an area where we begin to have conversations with organizations if they say, "We don't want more complex. We want simple." It might be that an outsourcing solution is not ideal for that organization.

Mr. Hirtle: That's a good point. Especially if it's mandated. In other words, what if they have a liability that is specifically a simple liability, and so they can defease it with a simple strategy.

Now I would make the case that those are few. There aren't too many that are like that, but that would be a specific issue. I would also make the case, though, that I'm not — Hirtle Callaghan is not — a consultant. We're asset managers and we have a strong opinion about how you run money in a fiduciary program. And we think it's a mistake to walk away from complexity, because the complexity, when used properly, is an advantage.

In other words, every one of those tools has its place. And a wise man once told me that 90% of the job was having the right tools, right? So it's kind of like — I always had this visual in my mind when I was a kid, the Sears catalog had the mechanic's tool kit. And it was sort of a big tarp on the ground with, I don't know, a thousand socket wrenches and screwdrivers and everything you could imagine would be out there.

And that's what the marketplace is like today, whereas 30 years ago it was kind of like the tool box that you sent with your kids to college. You know, one pair of pliers and maybe a screwdriver that reversed — you know, Philips head, straight head — and a hammer and that was it. It was very simple, but it was also very limited in what you could accomplish.

And so if you look into the logic of why, just in a simple example, of why a good long-short manager should be able to beat a long-only manager over time, that's an example of why complexity adds value.

And you could take that in every case. I'm a personal believer in a free market, so every one of these products, if it doesn't actually have a use, a good use, will disappear over time. In the beginning you might not see it, but over time, if it's not proving to be valuable in some circumstance, it will go away.

So I would say to people who are shying away from complexity, unless you happen to have a simple liability and can defease it with a simple plan, you don't want to run away from complexity, you want to embrace it, harness it and use it to make a better program.

Mr. Gepfert: Keep in mind that the perspective we bring is — it's not just the not-for-profits, it's not just the pension side, but it's also the DC side of things. And so outsourcing is a broad spectrum that talks about all of those potential investing areas.

And so you may be 100% right in your comments for the not-for-profit, I'm just going to pick an area, but that may be totally inconsistent with what you need to do if you're looking to outsource on the DC side of things.

Mr. Hirtle: I'd go to Kevin's idea, though, and say I'll do that inside a retirement-date fund. In other words, I will simplify the solution to the user. That's a simple solution. So I have one fund and it's going to take care of you. But inside of that fund, I need every tool I can get to run it as well as I can for the end user. So that's the way I would do that. To me, that's just my idea of harnessing complexity, delivering it in a solution.

So, I mean, the idea of a solution is simpler than a broad array of products that I have to assemble into a solution. I would differentiate the two that way.

P&I: Jay, can you elaborate a little bit on … what you were talking about before with the multiemployer plans, on how outsourcing is used by DC plans, because it would be different than how it would be used by DB plans?

Mr. Gepfert: … The way a multiple-employer plan is set up is you essentially outsource to a third party who becomes the plan sponsor and you become an adopting employer.

So rather than having all of us have separate plans for our own separate companies, we now become a part of one plan and become a part of a large group of employers that all come together. And the idea behind that quite simply is to be able to hopefully mitigate or reduce fiduciary risk.

And that's an area where when we talk about outsourcing, has not been traditionally a conversation here in the U.S. It's always been on the not-for-profit, on the pension side of things.

And I think for the private employers here in the United States, … this is a wave that has just started to build ... It may take five years or 10 years or 20 years or whatever else, but if litigation continues at the rate that it's going, it only appears that it's going to grow, and I think this is going to be a viable solution for not small companies. … Jon, I found it interesting in your comment, "We never thought this would be above $1 billion." Well, right now the multiple employer plans, they say "Hey, listen, it's probably not going to reach above 1,000 participants." Well, I think, in fact, it's going to be much larger than that.

P&I: What about corporate DC plans, and beyond target-date funds?

Mr. Gepfert: In terms of outsourcing?

P&I: Have you seen any? I know one example and only one example. There's a West Coast company that did it, and they did it I think because the staff just got tired of trying to get the board to make decisions. And really this was initiated by staff saying, you know, "Hey guys, we looked into this thing and here's a way that you don't have to be as involved as you were, and you know, take some of the time pressure off you and some of the fiduciary pressure off you." And so that's why they outsourced. It's a large, multi-billion-dollar corporate DC plan.

Mr. Quirk: Going back to what I said earlier, though, the DC market obviously changes a little more slowly than the DB market because you have to rely on the flows over time to change.

And so we've done a lot of work in this area, and our view is that if you just take target funds as a percentage of the overall DC market … by 2018, it's a very significant majority of the overall DC market.

That's going to completely change the landscape of the DC market, because effectively what you have now is an outsourcing market. … There's going to be so much more focus on performance, on structure, on process, and you're only now beginning to see this.

I think in less than 10 years we'll characterize most of the DC market as an outsourcing market.

Mr. Mateyo: Do you think the brokerage window as an option …. will that also be expanded over time?

Mr. Quirk: That's probably right. Although on the other hand … there's an interesting dynamic going on in the plan sponsor market. … (As the) corporate defined benefit market shrinks, many of the professionals who were in the defined benefit plan have begun to transition over to the defined contribution plan. So the attention and focus within the corporate retirement world is beginning to be much more focused in the DC area, and you're seeing seasoned professionals, investments professionals, migrate in and begin to focus on that part of the market.

One of the things that I think a lot of these people care about is their fiduciary responsibility, and so they're putting a lot of attention and focus on trying to clarify and understand their fiduciary responsibilities.

So on the one hand, yes, they may be thinking about that brokerage window as an option, but I think more than anything they're really trying to whittle down the options and manage this in a more aggressive way where … the participants are making smart choices and not exposing, frankly, the company to undue liabilities.

And obviously the (Pension Protection Act) was a huge step forward for them, by allowing target funds to be the default option in DC.

P&I: I think they have one more issue, too, that hasn't plagued DB plans the way it's plagued DC plans. I think the fear of litigation is huge among corporate DC plans .

Mr. Gepfert: Right. A pension plan or endowment, foundation … they have a financial risk, because you have to have an obligation to pay off a pension … or to have the endowment or the foundation set up to be able to do some spending. On the DC side of things, it's more of a fiduciary risk of, "How do I mitigate this as much as I possibly can."

And, Kevin, I agree with you on the target-date funds. I started my career with an organization that initially rolled out target-date funds 17, 18 years ago, and that's going to very quickly evolve, because plan fiduciaries now have to make two very major decisions. They have to decide on the glidepath … and, No. 2, you have to evaluate all of the underlying funds of funds as you would a core fund.

And without that ability to make those decisions, our opinion is that it's going to move to custom very quickly. Maybe a firm like Cambridge, if you get into the DC side or 403(b) side of things, or, Jon, your firm … is going to be poised to be able to make some of those types of decisions, because there's going to be so much damn money in these funds that you cannot just have them in prepackaged models. …

As a fiduciary, you can't do it … there's a hell of a lot of money in those funds right now; there's going to be more, as Kevin, you had said. And … it's going to draw more litigation, because there's a lack of fiduciary oversight and there's a lot of money, and that's a dangerous combination.

P&I: But if you're a decent size DC plan and you take your DB managers and you blend them into being your target-date managers, the due diligence on evaluating the underlying funds already has been done on the DB side.

Mr. Gepfert: Absolutely. If you have a DB plan and if your assets are big enough to be able to pull all those things back together again.

Mr. Mateyo: And if the committees are allowed. … Because on the DC side, you often have human resources or benefits or however you want to define it, that's also involved in that mix, that might have other objectives.

Mr. Gepfert: Potentially. You have to think of it on the university side or hospital — you've got a 403(b) plan at this point. … The 403(b) plan limits right now the type of investments that can go into that, so you may not have that ability, where on the 401(k) side, there's more flexibility. But absolutely. You betcha.

Mr. Quirk: The other thing, just underlying all this conversation, is the attention to whole portfolio management, and probably the lack of skill that exists in the market to actually deal with that.

If you think about our industry, I always go back to the '80s and '90s where you had this consistent decline and secular decline in interest rates, yet wonderful equity market returns. And so you could put a 60/40 portfolio together of long-only bonds and equities, and generate a 16-, 17-, 18% return on an annual basis. It was really relatively easy.

And I think one of the unfortunate outgrowths of that environment was one where we built an industry that focused very narrowly on things. So you had to be very good at beating the S&P 500 or a value benchmark or a small-cap benchmark. So the industry began to organize itself around very, very narrow silos, and we spent a lot of time talking about how good a value manager is this firm, or how good a small-cap manager is this firm.

And, in reality, today, we're recognizing the much bigger questions of whole portfolio management, asset allocation, some of the things that you talked about before, Jay, on glidepath — these are really critical important questions that haven't been fully developed in the market.

So now you're seeing much more attention being paid to these things. But as the industry's grown, we effectively have this superstructure that was created to support these silos, and now, in some ways, that legacy superstructure is not serving the market very well. I think a lot of the participants in the market are much more focused on whole portfolio management, and as a result, I think you're going to see a tremendous amount of change and innovation and, frankly, new market leaders in the business that will be oriented around their skills toward whole portfolio management.

P&I: And who might those leaders be?

Mr. Quirk: I think it's up for grabs. … It could be the investment managers themselves, typically the ones who have broad investment capabilities. It could be the investment consultants. Clearly the investment outsourcing firms are making a big push in this direction. It could be the funds of funds.

There's really a lot of potential … players here who obviously have experience.

Mr. Hirtle: I'd make the case that this notion we call — Kevin mentioned total asset management, we call it universal asset management — we think it's a different skill set than what most firms have. And interestingly, it's also a different skill set than what most committee members have, even if they're experienced investment people.

They'll come to the committee knowing about how to pick a stock or knowing about how to buy a good company as a private investor, but the idea of managing assets across a globally diversified, multispecialist-manager, risk-managed program, is a skill that is pretty rare.

And one of the places where people have it is in the macro hedge funds. But those people aren't willing to work as CIOs, as an outsourcer. It's a different set of economics. So it's really that same kind of universal asset management across all assets and managing with some sort of a disciplined process.

What we see is that — it's interesting to me that very few committees really evaluate their efficacy on making macro decisions. How effective have their macro decisions been? They're measuring the heck out of all their managers and how effective were their decisions on picking small stocks or large stocks or growth stocks or value stocks, but they're not valuing the committee's decision, or not measuring the committee's performance on macro decisions.

So this notion of what we call capital allocation — which … is not 'What is my overall asset allocation over time', but, "How is that portfolio positioned today" — very few people have a disciplined program for that. And very few people are measuring how effective it's been. And I think that's going to be one of the improvements in the marketplace. Technically, that's a huge difference. That's a huge gap professionally in the marketplace today.

Another thing I was going to say, because we had this conversation about DC and fiduciary liability and so forth, it's kind of interesting to me to look back and to realize that the whole 401(k) program, the DC world, was really an unintended consequence of ERISA. You know that in 1973 and '74, we had two bad years: down 15, down 25. So the government comes in and passes the Employee Retirement Income Security Act. We have ERISA, and now corporate officers are liable for the prudent management of the DB plan. So basically, it was sort of the demise of the DB plan. It's not completely dead, but it's certainly diminished.

And yet, we now see with the retirement-date funds, what basically the end user is saying (is), "I really want the effect of a DB plan." So what we're trying to do is create the effect of a DB plan in a DC format, and it's just fascinating to me how it's come full circle, and we're really responding to what that end user wants, which is a solution, not a bunch of choices.

And, you know, when you think about committees saying, "Gee, we're not really comfortable making all these decisions in this global marketplace," well, why would an employee be comfortable making all those decisions without any help, or with very little help anyway?

So I think it's more and more of this notion of the retirement-date fund … and maybe the lifestyle fund, which sort of preceded the retirement-date fund. You know, it's a little less specific, but still a packaged solution is where that goes.

P&I: OK, Bruce. Your turn, finally.

Mr. Myers: I think the thing I would like to follow up on is this concept of solution or solutions, and the notion of having a lot of tools in your tool box, and also, Jay, your thoughts about there are some organizations that really shouldn't outsource.

One of the things that my firm and Jon's firm long ago agreed to disagree about was the importance of having a range of solutions. For the non-profit institutions we serve and the families we serve and the governments we serve, they all bring us such a wide range of unique situations: the degree to which they are in the debt market; the degree to which their endowment supports their operations; the degree to which, in a family situation, founder stock might occupy a significant portion of their assets.

All of those situations — and I could go on and on and on — require different solutions. And the one-size-fits-all — while it may very well work for a lot of institutions, and that's great, because it makes their decision a whole lot easier — for most institutions and most families and most governments and most corporations, it's a trickier matter, because you have to figure out which solution is right for you. And it goes to this issue of there being a spectrum of outsourcing options and what is right.

And in some fashion, I think you have to go through the work that Gettysburg did in trying to figure out where are our strengths as an institution, what will we retain, and where will we outsource and where will we keep discretion, where will we give it away.

P&I: We'll move on to another question. Where do you stand on the issue of whether investment consulting firms should also be providing outsourcing services? What are your thoughts on the possibility of conflicts of interests?

Mr. Myers: Obviously, I speak as a representative of a firm that does do both. That in and of itself may be a conflict, probably. We think consulting firms certainly can be an outsourcer. Whether you're a consulting firm and you're not currently in that market and you're thinking about whether or not to get in, again, goes back to the point that Jon raised about do you have the full set of tools in the tool box. Do you have the depth of research, the global coverage, the ability to add value in alternative assets where management selection is still very important? The ability to make tactical moves across asset classes?

If you have that sort of investment acumen in-house, then I think you can be an effective outsourcer.

They are different things. They are different animals. Again, we're a firm that does both. We've done both for a while. In some cases even, we have employees who are doing both.

It's a different skill set. I would absolutely agree with Jon. To be a successful outsourcer, is a different skill set than to be a successful consultant.

Not to say one firm can't do both, not to say one person can't do both, but they are indeed different.

P&I: Long before there was the term "outsourcing," there were managers of managers and funds of funds. The reason I presume that you have the capabilities is because before there was outsourcing, you did that other stuff.

Mr. Myers: No. We've never done fund of funds.

P&I: OK. So, then how did you get the expertise in outsourcing?

Mr. Myers: We've seen it always as sort of a natural continuum that has grown organically out of our consultant work. … because we've always customized all of our solutions for the individual clients, we've always had a range of clients who were willing to rely on us in a different degree and to a different extent, and eventually we came to the point where after a particular client's staff had turned over on them, they had been relying on us to a degree that they were willing to just outsource the whole function to us and that was the beginning of outsourcing as a stand-alone.

P&I: How long ago?

Mr. Myers: It was about seven years I think.

Mr. Quirk: Nancy … you asked about conflicts of interests. I've struggled with this one. I see conflicts of skill sets, but I have rarely been able to truly isolate the conflicts that exist between the businesses.

What do you see as the conflicts between consulting and investment outsourcing?

Mr. Myers: We've always been perhaps a little bit phobic about — we've been a whole lot phobic about conflicts and have sought to avoid them wherever possible, that's why we've never had funds of funds of our own, because we didn't understand how you could be objective in evaluating your own fund of funds.

So I think it would depend on the degree to which the consultant is in a position where they're recommending a pre-packaged sort of off-the-shelf product that the outsourcing wing of the firm might be responsible for.

I think when you've got that sort of a dynamic in play — and there are a few firms where it is in play — then that does raise some question about conflicts.

Mr. Quirk: Sorry. But even if those funds, seemingly they're a fund of funds, so they're meant to represent their best ideas in the form of a product, is that even a conflict? Again, I just — I struggle with how big a conflict this truly is.

Mr. Hirtle: Historically, there have been a lot of consultants over the years and some of them don't exist anymore, but historically the consulting industry used to also take fees. Some consultants take fees from managers.

Mr. Quirk: That's a conflict. That's a huge conflict.

Mr. Hirtle: So that would be one. And I bet they're still out there somewhere, if you get into a small market or something.

The other thing is some of these consultants were broker-dealers, and you were trading soft dollars and probably getting paid. So that would be another one.

The third one, which is a little more esoteric in my opinion and hard to get your arms around, is the notion that historically — and this goes back to the notion of how you actually manage a universal portfolio — there's a lot more focus on the managers historically than we think is appropriate.

This notion of manager search and being paid by the search … that in and of itself can be a conflict. Because rather than saying, "Look, this is a good manager whose portfolio hasn't really gone up yet, just sit tight." Is there a conflict to say, "Well, let's do a search and get a new growth manager, because the growth guy's under for lots of different reasons."

… (and) there was that Emory study that came out a while ago now that studied $1 trillion of assets for 10 years, and it really showed the manager hire/fire decisions as destroying value. Well, that was consulting driven.

I mean, all those big funds had consultants, so they're bringing in managers that have great one-, three-, five-year track records, which statistically indicates that those portfolios are likely to be overpriced. So you're hiring a manager at the peak, riding him down, firing him. Hiring another manager at the peak, riding him down and firing him.

So this notion of being paid by the search and not having the discipline or the acumen or the skill set that's required to allocate capital into maybe a cheap asset, a cheap beta, hiring a manager who is being measured the traditional way, looks like he's got a bad performance, ...

So I see those conflicts where they exist, and I had to actually think about this one for a while, because it doesn't seem that there are too many left. But if I dig down to say where are the conflicts with the consultants, it's all about that manager, I think, the focus on the manager.

Mr. Quirk: So there's two things there, though, right? I think you'd agree that if the consultant was being paid on a retainer basis or a percentage of assets under management, and not on a search basis, that would significantly mitigate the incentive risk, right?

Mr. Hirtle: Yup.

Mr. Quirk: And then it comes down to — what I always come back to, is — does the firm have the skills to be an effective outsourcer or not.

Mr. Hirtle: And I would make the case that it is a very different skill set, as Bruce said, and I amplify that. And I'm sure that if the guys in Cambridge Capital Advisors that are the CIOs were here, they'd probably say the same thing.

You know, I always feel like if you wanted to be accountable, you wouldn't have been a consultant, so —

Mr. Myers: Ouch.

Mr. Hirtle: So it's answering questions as opposed to making decisions.

Mr. Quirk: Does that apply to management consultants too?

Mr. Hirtle: No. Of course not.

Mr. Quirk: OK. Thank you.

Mr. Hirtle: But the whole notion that — for example, when oil prices were at $150 a barrel a few years ago, many of the consultants were saying things like commodity exposure has a diversification benefit. Well, what they mean by that is that it's got a low covariance with some of the other asset classes, and so over time, if you have commodities in your portfolio, you can enhance your compound return.

Well, if you overprice, overpay for the asset, if you buy it at the wrong time, it destroys the diversification benefit. So the idea of making just the academic point that commodities can add diversification to the portfolio is not enough. You have to say, "When do I buy it?"

It's like Bain telling you that Dell computer is a good company. OK. Is it a good stock? That's a different question. And it's pretty much driven by price. So an asset manager is going to say yes, it's true that commodities, over time, have a diversification benefit, but we're not going to buy them when the oil's at 150, because that looks like a bubble to us. And so they're going to wait until they can buy that asset cheap, so that they get diversification benefit without destroying it on price.

So there's a difference between being an asset manager and being a consultant, and that's an example of what I mean by that.

Mr. Myers: I'm not sure that's the difference between an asset manager and a consultant. I think that's the difference between an astute investor and somebody who shouldn't be in the business at all.

So I would see it less as a generic indictment of all consulting firms, and just a very true statement about how not to behave in terms of —

Mr. Quirk: And I would add, perhaps I sit in a bit more of an independent perspective on these things, … it comes back down to skill set. And I think that, like everything, if you sit in Chris' shoes or George's shoes, for example, and you have to go out … and evaluate all the different potential providers that are out there. My guess is that if you looked across the landscape of dedicated outsourcing platforms, money managers, investment consultants, funds of funds, many of them who have migrated more toward outsourcing over time, you're going to see strengths and weaknesses, you know, across all of those business models.

Mr. Myers: Absolutely.

Mr. Quirk: And I'd also add that Jon's criticism of the consulting industry by and large, on a very broad basis, is actually a very fair one. I think there's only a select number of investment consultants … that are going to be able to compete effectively in the outsourcing space going forward.

Mr. Gepfert: My only comment … is follow the money. Which is, if you want to know where the conflicts are, just follow the trail of money down to recommendations that either the consultant or the outsourcer, whatever it is, make.

So, as an example, … if you have an outsourcer that has a commingled fund of funds in the alternative area … and they are also responsible for helping the investment committee make an asset allocation decision — put 10% into alternatives, put 15% into alternatives — well, OK, (you ask) why? Why are you suggesting that? …

If you run that down, those four or five questions … you begin to find out that there's a potential increase in profitability in the magnitude of two to five times, depending upon how they're being paid, right?

So to me, that becomes a conflict. Not necessarily of an investment manager and consultant, that's a conflict that can be inside of the potential provider you choose to outsource with.

Mr. Hirtle: There's a question here …: What would you tell somebody is a requirement going in if you're going to choose an outsourcer? To us, No. 1, is no conflicts. Zero. Absolutely none.

P&I: For consultants who are offering outsourcing services, is there a difference in price? Do you charge more for an investment outsourcing relationship? Because, Bruce, it's pretty clear that you're managing some pretty substantial pools of assets on behalf of the clients. So surely you must be getting paid something for that, beyond a regular consulting relationship arrangement.

Mr. Myers: Right. The way we see the difference is a traditional consulting relationship is frequently very specific in what the client is requesting us to provide them with assistance on, and it's bid out based on the requirements and the degree of assistance that they need.

The more comprehensive relationships, where we're serving either as an outsourced CIO or a staff extension … it's a basis-point of assets (fee). And even a fair number of our consulting relationships where we're working in a not a comprehensive way, but in a more limited and defined way, are actually bid out on a basis-point basis; obviously that's a lower number. So the vast majority of our revenues are coming from asset-based fees rather than search fees.

P&I: So, Chris, when you were … deciding, did you look for other outsourcers? You are Cambridge's client. Did you have a look at this whole issue when you were making up your mind?

Mr. Delaney: Yes. I mean, we cast a net of about 10 different providers and ended up (with) three that had an ability to … advise on components of our portfolio, namely the alternative assets … And through that process … Cambridge sort of stood out.

This might get back to another question that you raise. Again, access to the best-in-class managers. … strong risk management … services or process. Again, specialized investment services was definitely importantSome of our larger colleagues often use Cambridge just for hedge funds, you know. They have a CIO, they have their own staff, but in the area of hedge funds, they'll rely on Cambridge for that. Ours was a little bit more broader.

P&I: The other two — you said you found three that could handle the alternatives — were the other two also consultants?

Mr. Delaney: Yes.

P&I: What consideration did you give the potential for conflicts of interest using a consultant?

Mr. Delaney: In terms of the endowment, I don't think conflicts of interest came up. It … has come up more recently. We're also in the process of trying to find an adviser for our 403(b) plan. … We have an internal investment committee that's a non-board committee, it's staff. We need an investment adviser and put an RFP out. And basically, the (provider)recommended their own adviser to serve as our adviser. And right off the bat we said we can't. As much as we'd like to, we couldn't use that avenue because there's a conflict there.

On one hand, they would be advising us on your funds that are included in the investment menu, as well as they're advising you on the same fund. So that's the only conflict of interest that sort of came up on my end.

I think in terms of funds of funds, I think it's more of a preference … is it cost effective to go to fund of funds vs. direct investment? And our board has leaned toward wanting to do direct investment.

P&I: George, any issues with consultants?

Mr. Mateyo: Well, prior to us retaining an outsourcer, we used a traditional consultant. We didn't make the switch because we were concerned about conflicts. It was more because of — maybe efficiency of decision making; having an adviser really advising rather than making recommendations to the committee was a big thing for us.

Clearly we didn't want to take on unnecessary conflicts. We were very careful not to retain a firm that had proprietary products ... We directed our outsourcer (by saying): To the extent that you do have the fund-of-funds approach, we really don't want any part of that. If there is a recommendation for that, our internal staff vets that very thoroughly and decides the cost benefit of doing that.

We have, for example, a smaller asset pool within the Cleveland Clinic whereby that structure makes a little sense … (in that) it's a smaller amount. We still want exposure to alternatives. But to hire or to build a portfolio of hedge funds, for example, with a total portfolio in the $10 (million) or $20 million range, for example, … it's hard to do that on a separate-account basis.

So we're thinking about structures like that where it might make sense, but at the same time, being very conscious of the fees involved, who gets paid what. That's the point that Kevin made earlier about where the fees are, and Jay's point about following the money is something we're very sensitive to.

We were pretty emphatic about no conflicts right off the fence, but the decision was really driven more by process, and understanding the subtleties within the outsourcing arena as to how to find a manager that really fit with us. You know — what are their processes? What do they emphasize?

We talked a lot about managers that focused just on manager access, for example, vs. portfolio structuring, and a lot of other qualitative factors, too.

P&I: How is the role of the investment committee and the internal investment staff affected by going to outsourcing? And what's the division of fiduciary liability between the plan sponsor and the outsourcer?

Mr. Mateyo: We wanted the outsourcer and internal staff to have flexibility to react to market environments and make tactical decisions — rebalancing, for example, without having to wait for another committee meeting to go back and take 2% out of domestic equities … or something like that.

Again, for more strategic decisions, more complex strategies, some of the more idiosyncratic and esoteric strategies, those things should also still get vetted at the committee level.

Manager selection, same thing. If there's a really unique strategy, it makes sense perhaps to have the committee review that ahead of time. Often times, though, the outsourcer and officer are looking at that in tandem, so we really have a lot of that done independent of the committee. …

An extension of the question is the focus at the committee meetings on strategic issues, longer term thinking: having the committee reflect on the macro environment. What were we thinking three months ago? Does it still apply? Does it still hold water? What are the asset allocation decisions that we should be making?

Not that we're revising policy every 90 days or so, but (rather) is this the right course of action given these economic variables, and confluence of events that makes us believe in what we're doing. Do we still have conviction in what we're doing?

P&I: What about the investment staff? You had said your position was new as a result of that?

Mr. Mateyo: It was kind of coincident to us hiring an outsourcer.

P&I: But were there people, internal investment staff, prior to hiring an outsourcer?

Mr. Mateyo: Yes and no. It's an interesting answer, because our overall treasury function was really restructured around the same time. In the past, the treasurer was responsible for managing the debt, for overseeing the investment portfolio, for making sure the pension was funded and on and on and on.

Our CFO, at the same time he was rethinking the traditional vs. outsourcing consulting model, said, "Let's shape the treasurer's role and really kind of dismantle it," and the treasurer's responsibilities were really kind of broadly distributed across the organization. So we don't have a treasurer at Cleveland Clinic right now. We have a person and a team really that manages the debt portfolio, and makes sure our governance is being maintained, making sure the banking relationships are being adhered to and also managed appropriately.

And then my role was really an outgrowth of that, by saying we need to have an investment expert in-house, really maximizing the relationship with the outsourcer and really leveraging that effectively to our organization internally; and also, bringing forth information regarding the institution, regarding the balance sheet and considerations we might be having with respect to managing our business, and how that may impact the investment portfolio and decisions we might make with the investment portfolio.

P&I: So it was restructured. But was the staff cut?

Mr. Mateyo: No. It was realigned a little bit and people's responsibilities have shifted, but you know, I don't think there was a big kind of gutting of people.

P&I: Then what about the division of fiduciary liability before and after outsourcing? How much did you retain and how much were you able to give away?

Mr. Mateyo: I struggle with that question, because I don't think it's a black or white answer. I mean, I don't think you give away 10% and you keep 90(%) or something like that. I mean, you know, you're not half pregnant. You're a fiduciary and you're liable, and if there's bad investment, then I think everybody pays some price for that to some extent.

Maybe the perception that the level of fiduciary risk is minimized slightly by having an outsourcer ...

P&I: Or at least shared.

Mr. Mateyo: I think it's probably more shared. But, again, I don't think it's changed all that drastically by hiring an outsourcer.

P&I: So I think the analogy I would use as a taxpayer, having somebody else prepare my taxes, means if the IRS ever calls to audit, I'm not going to have to go in there by myself.

Mr. Delaney: Right. But it doesn't absolve you of your responsibility.

Mr. Mateyo: You're still going to get a phone call.

P&I: Right. But I don't have to go by myself.

Mr. Quirk: But you'll be the one that goes to jail.

P&I: This is a question for both George and Chris. … If the world starts to melt down again, can your investment committee say "Stop everything; we're not going to do anything."

Mr. Mateyo: Sure. It's still our money … that's maybe the point of the committee also going forward. That if we felt that the direction that the outsourcer was going … was completely crazy or not grounded in some kind of logic or reality or, you know, just really not appropriate even — if we just felt like this is really misaligned with our objectives as an institution — we have every right to say time out and let's not go forward.

P&I: Have you given them a time out yet?

Mr. Mateyo: No.

Mr. Delaney: In the two years that we've been with Cambridge … at no point did they ever make an investment without telling our board that they were going to do it. It wasn't like, you know, they came in and said, "We met last June, and you know, over the past three months we made the following changes." That's never happened.

They approach the committee with "We've gone through our internal process" — remind the committee that they have their own internal investment committee where their team makes recommendations, it got approval — "and these are the changes that we are going to move forward on." And they're not asking for approval, they're just sort of, you know, looking for an endorsement, almost to have a discussion to say "These are the reasons why we're making these tactical shifts."

... It's not a black box, this outsourcing. It's still a very open communication.

(On) the issue of fiduciary responsibility — again, the bottom line is the board retains the fiduciary responsibility over whether it decides to hand out certain responsibilities; it's still responsible. That's something we'll be doing probably over the next six to 12 months — evaluating Cambridge now that they've had the portfolio for a full year or so, year and a half, and have implemented it, evaluating it in the areas that they've been given discretion.

So I think you'll see the role of the committee evolve from … choosing within three great investment ideas for a particular asset class, to OK, this is why we hired the adviser, these are the reasons, and let's evaluate — not just the board evaluate, but the staff evaluate.

Before Cambridge, we used to do all the performance reporting internally — we actually started this process looking at a custodian and then we flipped it — … (and) that was the biggest single change of work for us. We got out of sort of the business of performance reporting and were able to turn that over to the adviser, as well as give the committee attribution analysis, which we could never do, which in terms of risk management, was an area of interest for the committee.

What that's allowed me to do now is reprioritize my time to focus on communications to our community about how the endowment's managed, and the fact that we are small relative to our peers, and that, you know, this is how we manage our money, we manage it well. Sort of educating folks, you know, on how we do that, as well as encouraging them to donate more.

P&I: What about other staff? That's how your job changed, but are there other staffers whose jobs changed also, whose jobs were eliminated?

Mr. Delaney: No job elimination; it, was more of a shift of responsibility. Again, when we did this change … liquidity was the big topic, and a lot of time was invested in coming up with ways of educating the board on what "liquidity" means for the endowment and what "liquidity" means to the college's balance sheet as a whole and bringing in the debt portfolio.

So having a broader discussion, not just on how the endowment's invested, but what's the implications on our entire balance sheet.

Spending is another one. … The spending policy is really the area for the finance committee at Gettysburg to sort of decide on and vet on. Together with the endowment committee, they have those conversations around that.

So there wasn't any change in staff … it was just sort of a refocusing.

Mr. Quirk: I've got to imagine the one thing that feels different … the agenda and the dynamic of the investment committee meeting on a quarterly basis must be totally different.

Mr. Delaney: Totally. And it starts out with a discussion of, you know, Cambridge's best thoughts or recent thoughts on the market and market conditions. It then leads into sort of tactical discussion, and in the past that was not really happening as rigorously — because of time constraints. I mean, in the past, you were choosing managers. You had manager interviews that took up half a meeting, and you were trying to come to consensus on one of three. Now it's focusing more attention on what everyone here is saying is the most important area, your asset classes that you're in and sort of the macro level.

Mr. Gepfert: The … level of discretion that's taken by the outsourcer and the size of assets drives … what realignment of staff could potentially take place ... And that doesn't mean that people are eliminated. They may just have different full-time jobs — they may not have a full-time job running the endowment or the foundation or whatever else, but they may spend less time on that and more time on something else that they have responsibilities for.

P&I: But they still have a job.

Mr. Gepfert: They still have a job ... But at the same time, the investment committee then takes a look — eventually, once they get into the relationship with the outsourcer — and says, "OK, … if I was staff, what's the most effective use of my time," in conjunction with the president of the school or the foundation or whatever else and how to allocate those resources in the amount of time it takes place.

Mr. Hirtle: I think most of the people that are hiring outsourcers do not have a full (investment) staff. In other words, they're getting to a point where the people that are working there are overwhelmed, and so they're asking for help. It's not that there is not enough work to go around; there's way too much work. And so now the guy that had six hats on, now has three hats on.

So that's what I've seen. Maybe we'll see in the future big staffs, you know, big multibillion-dollar plans, switching to outsourcing and then you would actually see staffs losing their jobs. But that hasn't been very common.

P&I: Isn't there a fear of that, though?

Mr. Hirtle: I haven't run into that yet. As I say, most of the places where we are being engaged, they are replacing an old model where there is no managing fiduciary.

One of the books we use all the time is a book by a guy named Keith Ambachtsheer called "Pension Fund Excellence." In that book, he's got that model where he says there're three levels of fiduciary responsibility: governing fiduciary, managing fiduciary, operating fiduciary. And what we're talking about is the managing fiduciary line. It's that middle line; the day-to-day function responsible for the program.

The governing fiduciary … they are still there. And the operating fiduciaries are the guys that are picking the securities. So that managing fiduciary line — whether it's outsourced or internal — it's the same function. …

So I think what we try to do is make our relationship with the governing fiduciaries as much like staff as possible, just as if we were working there … that's our goal.

P&I: George, did you have a consultant before you went to outsourcing?

Mr. Mateyo: Did the clinic?

P&I: Yes.

Mr. Mateyo: Yes, a traditional consultant.

P&I: So do you still have that consultant?

Mr. Mateyo: No.

P&I: And that's one of the outcomes of going to outsourcing — you don't need your traditional investment consultant now that you have outsourced?

Mr. Mateyo: Correct .

Mr. Gepfert: I think Chris brought up a really good point at the end of his comment, which is how the committee meetings are. One of the things when we're chatting with folks is that that's a really key point. The committee meetings typically, when you're using kind of an older model with a consultant, … is that it's much more kind of reactive in terms of what the committees are like vs. when you go to an outsourcing model. Because the outsourcer's doing most of that kind of reactive work, the committee meeting has become much more proactive.

P&I: And anticipatory.

Mr. Gepfert: Exactly. Look forward in time vs. looking back in time to see what has already taken place. As we all know, you look back in time, you can't fix it. The only thing you can do is try to look forward in time.

So I think Chris' point is a really key point for why an investment committee would want to think about that. It's a very different perspective of how they would manage their meetings and the types of decisions that they would make …

P&I: One question that's really hard to get an answer for is: What's performance like in terms of meeting expectations and actually delivering what's promised?

Mr. Delaney: I'm going to use the phrase that Cambridge called it themselves — "a qualified success;" they're slightly below their benchmark for the portfolio for the year.

But, again, it was the first year. There was a lot of transitions. So it's really too early for us as an organization to say, you know, yea or nay.

I know overall from the staff perspective, from the board perspective, we're very, very happy with this model and the way the past year and a half has gone, and the confidence that we have in the manager.

But in terms of performance, again, it's kind of early for us to tell, given that we've had so many shifts in the portfolio.

P&I: Jay?

Mr. Gepfert: I think what we've seen is wide variability in terms of the performance. In fact, I think one of the reasons there are so many outsourcers today vs. 10 years ago, is that some of those relatively small number (from 10 years ago)… didn't have the performance, and so the concept of outsourcing was fantastic, but the actual performance of the portfolio didn't match up to the promise. …

P&I: The firms that provided those iffy results, are they still in the business?

Mr. Gepfert: Sure … there's a niche for everybody in the marketplace. And obviously they always struggle with trying to make sure that they get their performance up. ...

But, I mean, the business that Bruce and Jon are in, it's a damn tough business. Just going (to) outsourcing doesn't mean that you've got a magic wand now and everything changes and everything is great.

I credit them for their skill and success that they've had so far. It's a tough, tough business. Which is why the committees have said, "Hey, listen, maybe there's another way in which we can look at this thing. Can someone else make a decision better than we can?"

P&I: Bruce?

Mr. Myers: Well the short answer, of course, is we better perform and we better be able to meet expectations over longer periods of time, or we won't stay in this business.

Measuring success is a tricky matter, clearly. Especially for us, perhaps, because we'll take portfolios whole. ...

Others, quite legitimately, require cash in and deliver back cash out. So their performance is a little cleaner to measure. There usually is a period of transition in our portfolios, because we're not requiring cash in.

So as long as everyone's mindful of the nuances of performance measurement as a general rule, I think we've got to be able to meet and exceed expectations.

P&I: For some of those clients you've had for seven years, are they still with you?

Mr. Myers: Yes.

P&I: Has performance then smoothed out, once you've cleaned up the portfolio? Once you transitioned the stuff that really wasn't working in there, did performance improve with those clients?

Mr. Myers: Yes. They're quite content. Again, we've not lost an outsourcing client.

P&I: Kevin?

Mr. Quirk: You know, I'd echo what Jay said before. Our observation, whether you're looking at the institutional outsourcing market or you're looking at target-date funds — kind of everywhere we've looked — the variability of performance is actually quite dramatic. It's a pretty wide spread.

In the institutional market, performance is one of those things that requires a lot more attention. Right now, probably the best way to get your hands around understanding performance is to actually go through an RFP process and kind of force some number of providers to come to you and give you all the information you can get your hands on, including performance. But today, there's actually not a lot of transparency around performance. For example, there's no one that actually publishes this in the form of a database. That doesn't exist today as far as I understand it.

You don't have any kind of real compliance standards that exist on the outsourcing side, so while some that have real dedicated outsourcing platforms have very kind of deliverable track records, others have a much broader client base, (for) which it's harder to create a composite performance track record.

So I think performance in this market is still a very elusive thing to evaluate, and my guess is that what will happen over time. As it grows in importance … you're going to see much clearer measurement of performance, you're going to see more transparency, you're going to see more standards for how to actually present performance to the market.

P&I: Jon?

Mr. Hirtle: So as an asset manager, you want to have performance. On the other hand, basically … every one of our clients is a custom solution.

So it's very hard. You're really solving a problem, you're not just delivering performance. And what you're really trying to do, and what we spend an awful lot of time on, is defining the client's — what we just loosely call —their liability. … All investing is LDI; it should be liability driven, and there are three factors. The investment portfolio is a plug based on the operating risk, the financial risk and the constituency risk.

So we're going in, evaluating all that, and saying what kind of a program is appropriate to defease that liability, and what's your spending policy and that's all part of it.

The thing that is the most flexible about that is this investment portfolio. So, how do we measure performance? What we do is we have a very specific style that's valuation dominant. ….

So how valuation dominant the client is willing to be, is going to determine their performance relative to our 200-proof approach. There's a trade-off between performance and tracking error, because if they're more market sensitive … they can't be as valuation dominant. And if you think of the market having three factors — valuation, sentiment and momentum — if you dominate valuation, when sentiment and momentum are driving the market, you are going to be under. ...

What we do is we say, "Look, if you give us our pure play, (the) 200-proof valuation dominant approach has this performance over rolling three-year periods, which is how we prefer to be measured. If you want half of it, you can expect half of that performance. …

It's very much of a trade-off between what kind of risk do you care about most. Do you care about price risk, which is the risk of losing money, or do you care about tracking error risk — in other words, being out of step with your peers.

And we are very much of the camp that you should care about price risk, because that's real risk, and the rest of it is just peer pressure and we tend to not want to respond to that. But that is client specific. The client may not have the ability to be that. So we want to respond and create the portfolio. …

For example, in spring of '09, we were committing a lot of money into equities, buying high-yield bonds, buying REITs, recommitting. A lot of clients were saying, for whatever reason, "You're not allowed to do that."

So how do you measure that performance? That's very different.

And the final thing I'll say is … (the) performance question is kind of a product question, it's not a service question. And this is a service industry we're in.

This goes back to (what) Chris said: It's not a black box. It can be a black box, because there are some guys out there that are saying, "Look, let's take this endowment approach or pension approach, unitize it, and you just buy units." Well, that's more like a product. And the reason they want to do that is there's tremendous operating leverage by unitizing an endowment-like approach. But the business we're in is a service business. It's a solution business. It's a high-touch service business.

And part of that is performance. You've got to have the performance, no matter how good you are at everything else, or you're not going to be retained. But …. (there's also) a lot of interaction, and in the end, the committee's going to know whether you've done a good job or not, and performance is going to be part of it. That's what I would say.

And I think the performance has been there. I mean, in all aspects. We've got a 98% retention rate over 23 years … you know, they wouldn't be with us if they didn't like the performance.

But it's very hard to come up with a composite number, because everything's custom.

P&I: George, you're going to wind up the whole thing.

Mr. Mateyo: We have engaged our outsourcer for two years now, and there has been a pretty big ramp-up in terms of transition. We didn't just give them the cash, although we did give them some cash.

But it was, you know, a good six-, nine-plus months or so of retooling the portfolio and redesigning the structure, all the while kind of changing the tire of the bus as it's going down the highway at 70 miles an hour, looking for new opportunities and being cognizant that the market was still in a pretty big transition period, too.

But that said, we've been pleased. Performance has exceeded our benchmarks. To some extent, though, I would say that the committee's not actively focused on that. We're not looking at how much alpha have you delivered in the last year or two years in this case.

We have looked, pretty recently actually, at a difference of fee structure — what we were paying and what we're paying now and understanding that this was probably a bit more of an expensive option for us, although net-net, it's really not that material in terms of where we were vs. where we are now.

And I think more than anything, to the extent there is a smaller increase in the fee, our board is extremely comfortable and very satisfied with the changes that we did make — more at the governance level, things that were all talked about before — and feel like we're really getting more than our money's worth on that side of things ,too.

We've also gotten actually compliments from our auditors, which was pretty remarkable.

Mr. Delaney: We didn't even talk about that. That was like a paradigm shift for the amount of work that we would do internally to demonstrate our due diligence, our internal controls around investments. I literally had binders put together for years. Now we're at a new day. The accountants are very familiar — are very comfortable — with the work of the outsource provider and the way they go about their due diligence, their monitoring. I mean, it is clearly a new day in that area, and I couldn't even put a price tag to that.

But, again, all it did was free me up for doing other things that have come up in the interim. And for us, there's always — there's more and more government requirements and more and more requests for information out there. …

There's more to it, I guess that was my point, than just the performance of the fund.

Mr. Gepfert: My perspective on it is that the relationship in terms of the evaluation of the outsourcing manager changes throughout the time of that relationship.

So the first couple of years is exactly what you all have talked about in terms of the transition of the portfolio and … and things like that.

Pick some period of time further down the road, five years, pick any time that you want to. I think it becomes possibly a little bit less of that and a little bit more of "OK, can you show us kind of what you delivered here for this decision that we've made."

And then, if it's 10 years down the road, a little bit further in time, then it becomes, "Wow, I like this idea, but you know what, maybe we're not with the right outsourcer." You begin to get into … that whole conversation of the markets are beginning to evolve to a point where it's, "We're going to switch outsourcers."

P&I: And it might not be performance related per se, it could be the quality of service or just the meshing.

Mr. Gepfert: Right. So that's the one thing that we have found. And again, having been with an outsourcer, that's what I saw in terms of the evolution of the relationship … it was hard to pinpoint what those times are, but the beginning is certainly different than the 10-year mark.

Mr. Mateyo: There's a lot of qualitative factors that go along with that, too, which makes performance something that people can focus on, and maybe it's more tangible. But you can certainly look at so many qualitative attributes and stylistic kind of points. Are you getting transparency from your outsourcer? Do you have a good rapport? Do they have a sense of conviction about what they're doing? Are they humble about what they do too? Because as you all pointed out — it's really tough work, and you realize the markets can go against you for a while. You need to be adaptive, but humble at the same time.

Mr. Gepfert: It's really interesting to listen to you all here, because it just reaffirms why we decided to offer the services we did — which is the number of providers out there, the level of complexity, the varying levels of investment committee member knowledge and expertise and time to make that decision. You know, we kind of stumbled into it because we were doing it — members of committees that were helping organizations that we sat on make these decisions, and a light bulb went off and said, "Well, hell, we've been doing this for free, why don't we offer it as a service?" And to me, it just kind of confirms the direction everything is going as well.

P&I: We're past time to end. We could have done another hour easily on this. Thank you everybody.

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