HC OPINION

OCIO, My Foot!

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Outsourced Chief Investment Officer (OCIO) is one of the fastest growing areas of investment management. Charles Skorina, publisher of *The Skorina Letter* and the acknowledged expert on tracking growth within the OCIO marketplace, recently published a list of 103 firms who claim to be delivering OCIO services. When one considers what is required to deliver the benefits of OCIO — an independent investment office and your own Chief Investment Officer capability — the vast majority of those firms do not measure up. A real OCIO search begins by eliminating pretenders from consideration.

Summary

- **Traditional investment governance has been challenged by a tipping point of complexity and noise** brought on by globalization and investment product innovation. Consequently, Wall Street's buyer-beware social contract is long past its expiration date when it comes to serious investors with serious responsibilities.

- **The advantages of a sophisticated, conflict-free independent investment office with multibillion-dollar access are undeniable.** Decades ago, in order to deal with that tipping point of complexity and noise, sophisticated, multibillion-dollar investors like the R.K. Mellon Foundation and Yale University developed their own, independent investment offices led by a carefully selected, highly qualified C-suite executive called a Chief Investment Officer.

- **Outsourced Chief Investment Officer (OCIO) is an important, cost-effective innovation** that, when executed well, can deliver the advantages of a sophisticated, conflict-free, multibillion-dollar, independent investment office and transform Wall Street's archaic buyer-beware social contract into one of trust, collaboration and reliable success.

- **Confusion created by widespread misuse of the term "OCIO" threatens to derail its transformative power.** Growth in OCIO has attracted banks, traditional investment-product firms, consultants and start-ups who claim they too can provide OCIO services, despite structural conflicts of interest and cultural mismatches that disqualify them.

- **Three requirements eliminate 75% of the Skorina list leaving approximately 25 true OCIO firms for in-depth consideration.** When selecting an OCIO (or building an independent, internal investment office) wise investors will require a conflict-free structure, capability that is unconstrained by purchasing power and a point-accountable, investment-management culture.

Background

Serious investors provide the capital that fuels democratic free enterprise, by far the most powerful economic system in history.[1] For that system to work best those providers of capital must be represented with sophistication, complete objectivity, rigor and purchasing power. But, with few exceptions, they lack the purchasing power, governance structures, multidimensional expertise and full-time focus to consistently earn their fair compensation. Outsourced Chief Investment Officer (OCIO) promises to solve all that.

Although the past 10 years of historically positive stock market returns, particularly in the U.S., have made successful investing look like child's play, experienced investors know better. Managing return and risk in today's world is far more complex than it has ever been. The world was a much simpler place 40 years ago. Indexing, high yield bonds, securitized loans, hedge funds, private equity, venture capital, private credit, derivatives trading, just to name a few innovations, were largely in the future (to say nothing of globalization and the digital revolution). In those days our capital allocation decision challenge could be captured in a three-cell matrix: stocks, bonds and cash; U.S.

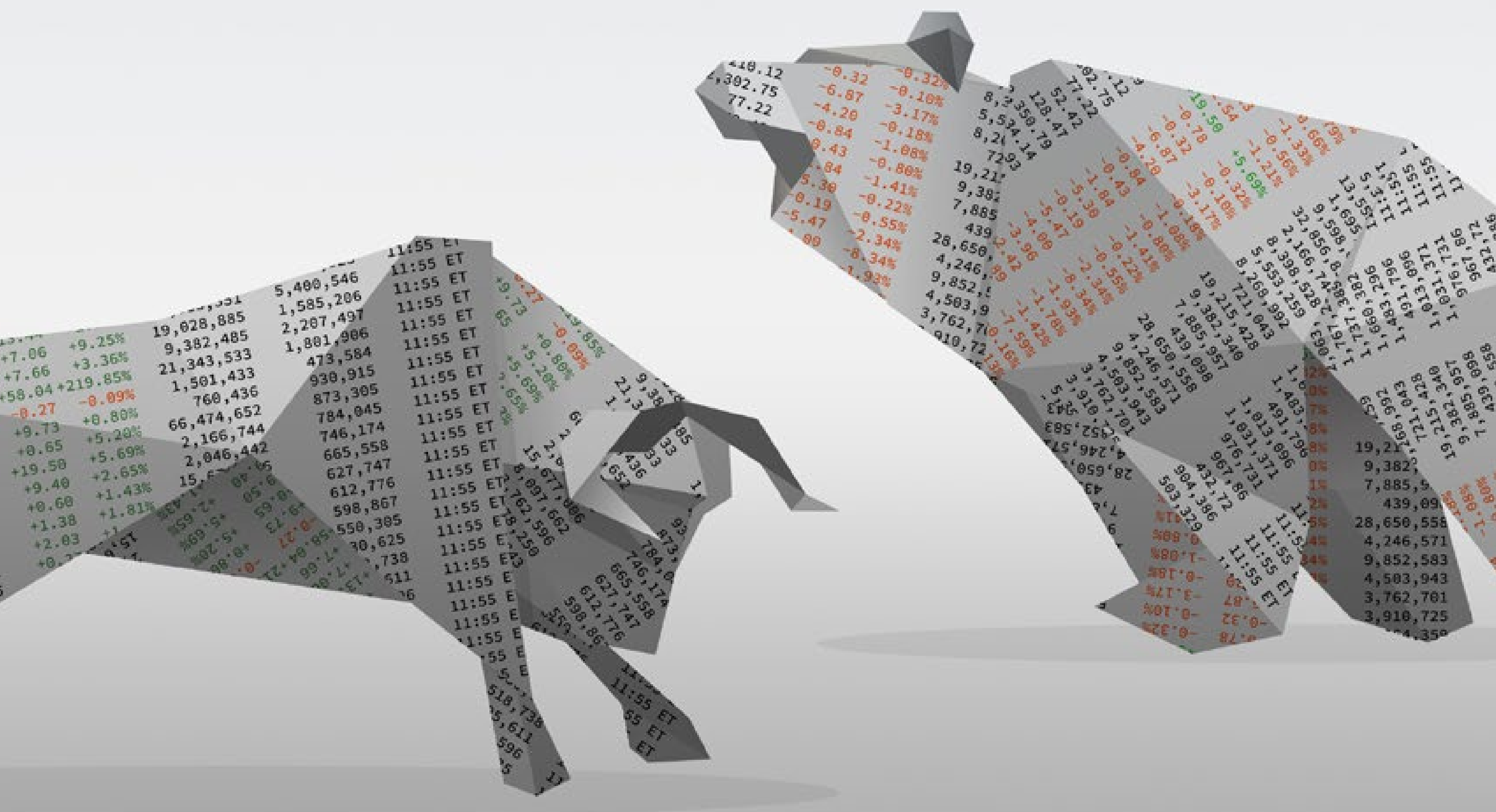
That simple challenge is long gone. Today's decision matrix displays every investable country across the top and every kind of 21st Century investment innovation along the side making the challenge something akin to 50-factorial. Yet, the governance model for most family, endowment and foundation investors remains unchanged from 40 years ago, with well-intended laymen or part-time professionals meeting quarterly. That model is insufficiently capable, lacks full-time focus and is far too slow-footed for the complexity and noise of the modern world.

Figure One: An Explosion in Complexity and Noise Leads to a Gap in Governance

[1] *We use "serious investors" to differentiate real investors from the traders, speculators and gamblers that the media regularly and inappropriately refers to as investors.*

Enter OCIO

When we pioneered the concept of OCIO in 1988 the idea was straightforward. We planned to replicate the critically important conflict-free structure of a sophisticated, multibillion-dollar independent investment office led by a Chief Investment Officer (hence that descriptor in our logo) and use its advantages to produce better, more consistent net results for our clients — clients who had inspired us with their trust. As more and more thoughtful investors recognize the power and promise of OCIO, it's time to review its requirements.



I. A Conflict-Free Structure

When I am asked what an OCIO does, my answer is simple, “The same thing an internal CIO does.” So, functionally, “CIO” and “OCIO” are interchangeable and, structurally, they should be identical.

The vast majority of the world’s most sophisticated, multibillion-dollar investors use the structure illustrated to the right. Coincidence? Hardly. *The first OCIO absolute is a structure that is free from any conflicts of interest.* Unlike traditional bank, broker and product shop models, an internal office sells no products, has no hidden fees and would never permit “side deal” compensation with vendors. And conflicts revealed are not conflicts eliminated. The long list of conflicts that banks typically list at the end of their proposals confound decision-making whether they are revealed or not. A conflict-free structure is the foundation upon which the institutional trust, true open architecture and cutting-edge solutions are built. The transformational benefits of OCIO are simply not possible with a traditional conflict-laden structure.

Why doesn’t Yale close their investment office and hire a large bank or Wall Street investment management firm instead? Because decades ago, Yale moved beyond the obviously conflicted constraints of Wall Street’s product-driven, hidden-fee, buyer-beware model to much higher ground. If Yale would not hire a bank, pension consultant or traditional investment management shop as their CIO, why would you? Years ago, the independent office model was not available to family investors or those who were responsible for a $300 million endowment; today it is. Authentic OCIO offers that same sophisticated, conflict-free, multibillion dollar high-ground structure to those who take their investment responsibilities seriously but lack the power of a fully formed, internal, independent investment office.

Figure 2: World’s Leading Investment Programs

Owners of capital employ a sophisticated, effective team of complementary professionals who work directly for the family or institution.

Members of the investment office work only for the family or committee. There are no hidden fees. This structure eliminates conflict of interest and, consequently, leads to better decision-making. Decision-making covers portfolio construction, risk management, cost management and access to truly differentiated skill.

Specialist money managers are selected solely for their demonstrated expertise and a specific role within a custom program. No hidden fees or corporate incentive programs affect which managers are hired or how many assets they are assigned. Each program is designed to achieve success with the highest degree of certainty, net of all costs. Fees and terms are negotiated using multibillion-dollar purchasing power. Ongoing supervision covers people, process, portfolio and performance at the specialist manager and program levels.

Complete Alignment of Interests

A CIO's interests must be completely aligned with the client's interests. Managing quarterly earnings, hidden often-shifting corporate priorities and the perverse incentives created by conflicts of interest impair decision-making. True open architecture, with no internal products to prefer over external ones is as critical as purchasing power when maximizing breadth. Predictable investment success demands crisp decision-making unencumbered by structural impediments or cultural tendencies that get in the way. Banks and product shops, who claim OCIO capability, often choose Manager A over Manager B because the B "product" has a higher built-in fee. An obvious conflict of interest; unacceptable.

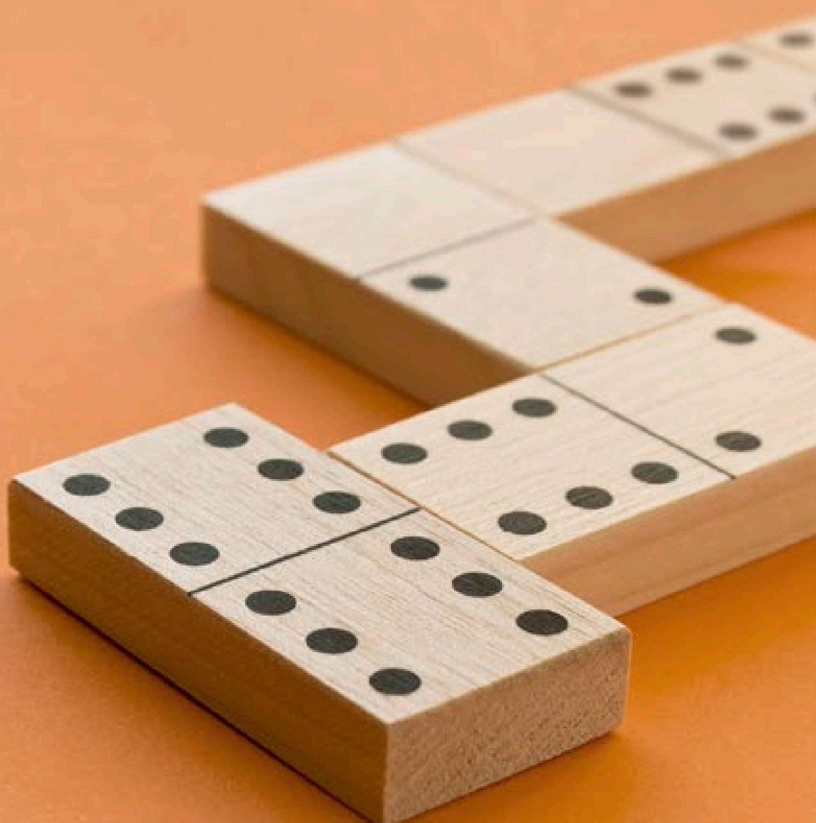
They also allocate more money into private markets, for example, because they get paid a higher fee whether it is in the client's best interest or not. Another obvious conflict of interest; unacceptable.

On a less obvious level, an advisor may emphasize an internally managed product because her boss's boss wants that product to grow, regardless of whether it is best for clients. Or she may hesitate to move out of an internally managed product because she got to know its manager at the company picnic. These are just a few of the conflicts that riddle the traditional investment management industry and they disqualify traditional firms from serving as an OCIO.

David Swenson, who until his recent death led the Yale Investment Office as the most prominent CIO in America, would never have tolerated conflicts like these within his office, nor would his committee. Why would you?

"Multi-Asset" is not OCIO

Another perversion of "OCIO" involves synonymizing it with "multi-asset." For reasons of risk management and increasing the certainty of success, substantial investment programs always include multiple asset classes. So, you might say that every OCIO program is multi-asset; ***but "multi-asset" is not OCIO***. Multi-asset is a term that banks and product shops use to sell their products as an assemblage rather than one at a time. It's just a different way to package and distribute their own often suboptimal funds. On its surface, a multi-asset product might resemble a program created by a real CIO, but it is exactly the opposite of authentic open architecture and true OCIO. If your financial future depended on the outcome of a track meet, would you bet on a decathlete to compete in every event on your behalf, or would you select a team of the world's best specialist athletes? Even the best decathlete in history cannot beat the team of specialists. The same is true with investing. No one firm has the best capability in every area. That's why great CIOs, unencumbered by corporate limitations or hidden agendas, select best-in-class *independent* specialist managers from around the world, negotiate their fees and fold them into a custom investment program. "Multi-asset" is not OCIO.



II. Purchasing Power

The next requirement of a fully capable investment office is multibillion-dollar purchasing power. OCIO has a co-op dimension to it, combining client purchasing power and wielding it collectively to pay for expertise, to buy data, underwrite the travel involved in manager search and so on.[2] We estimate the cost of an independent investment office with entry-level functionality to be between $2 million and $3 million per year. That includes an experienced, reasonably proven Chief Investment Officer with a small staff, some data, limited travel, benefits, office space, etc. The most complete offices, with real capability across all aspects of public and private markets including risk management and portfolio construction as well as exceptional earned access specialist managers, can have a staff of 20 or more with costs that increase proportionately. So, purchasing power matters. It is almost impossible for a firm with less than $5 billion of assets under management to find and support the talent required to exploit the full breadth of today's exciting but complex global opportunity set. And fully exploiting the breadth of global opportunity captures a tremendous advantage.

The Law of Active Management:
Success = Skill x Breadth of Opportunity

The simple equation above clearly illustrates the power of maximizing breadth, and its logic is not limited to investing. If you and I have the same skill in basketball, but you get twice as many clear shots, you win. If you and I have the same skill in investing, but I evaluate only domestic opportunities while you evaluate opportunities at home and abroad, you win. So, while all professional investment firms work to improve skill, improving breadth of the opportunity set is just as powerful. But because of conflicting corporate agendas or limited resources, banks, traditional investment firms and start-ups cannot maximize breadth. Legitimate OCIOs can.

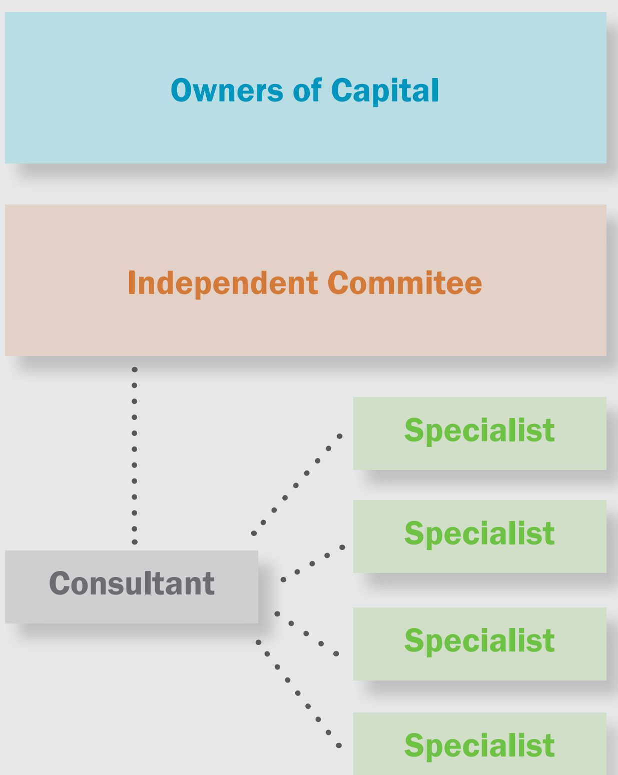
[2] The co-op dimension of OCIO means that many leading firms create pooled vehicles of execution to gain access to great managers and improve terms for clients, but real OCIO firms charge no fees in their pools and they should not be confused with products.

III. An Investment Management Culture is Critical

Peter Drucker famously said that "culture eats strategy for breakfast." In recent years, pension and endowment consulting firms have decided to enter OCIO. On the surface they sometimes appear qualified; they know the academic literature, and some present themselves as conflict free. The problem is that they are culturally uncomfortable with and unsuited for accountability. A CIO is an actual decision-making, trigger-pulling investment manager responsible for the success or failure of an entire investment program. Investment consultants are not investment managers; a CIO must be.

Figure 3: Investment Consultants Are Not CIOs

Contrast the figure below with Figure Two. The investment consulting industry arose out of ERISA (the Employee Retirement Income Security Act of 1974) which made corporate officers liable for the prudent management of their pension plans. Consultants, therefore, developed in a liability-avoiding CYA culture rather than a point accountable ROI culture.[3]



- OCIO ***requires*** a structure that is conflict free and truly open architecture with no products or hidden corporate agendas to confound decision-making.
- It ***requires*** sufficient purchasing power to pay for the talent and support to fully exploit global complexity, noise and opportunity.
- It ***requires*** a point-accountable, investment management culture.

These three essentials eliminate all banks, product firms, small firms and consultants: 75% of the Skorina list. If the R.K. Mellon Family won't close their investment office and turn their assets over to a large bank or a large investment product shop, and Princeton won't turn their assets over to an endowment consulting firm to forego their own independent efforts, why would you?

Serious investors understand that *governance matters*. Those committed to capturing the transformative power of the independent investment office model with a true CIO should exclude banks, brokers, investment product shops, pension consultants and small firms from consideration. Time is far better spent evaluating the approximately 25 legitimate OCIO firms on the Skorina list in terms of people, philosophy (hence process), portfolio construction and performance.

[3] Ladies and gentlemen of the investment profession know that CYA stands for Cover Your Assets, while ROI is Return On Investment.

Differentiating Among Real OCIO Firms

Once firms with conflicted structures, inadequate purchasing power and misaligned cultures have been excluded from consideration, differentiation among OCIOs can begin. The primary goal of this essay is to help separate legitimate OCIO firms from the pretenders, so I will touch only briefly on evaluating real OCIOs. The "4 Ps" represents a time-honored framework for selecting an investment manager and it's a great place to start when selecting the C-suite executive, called a CIO, to serve as the master investment manager of an entire program.

I. People

It should go without saying that absolute integrity is the first requirement of a senior-level trusted advisor like a CIO — not only personal integrity but an organization built on integrity with the culture, processes and controls to protect it.

Also, you and your investment advisor should click. There are too many true professionals working in OCIO for you to select a team who you do not trust, whose investment philosophy does not resonate with you or with whom you simply lack rapport. Once the essential requirements of trust and rapport have been addressed, it's time to dig deeper.

II. Philosophy (hence process)

When selecting a specialist manager as a role player within a total program, we expect the manager to articulate an "uninterrupted chain of compelling logic." Those hiring a CIO or an OCIO should expect no less. The overarching role of the CIO requires an investment philosophy that addresses:

- Holistic Assessment (to define success for each client and client account within a program)
- Portfolio Construction and Risk Management
- Identification of, and Earned Access to, True Specialist Manager Skill (alpha)
- Decision-Making and Performance Measurement

III. Portfolio

Simply put, the portfolios that comprise each client's program should be completely consistent with the CIO's articulated philosophy and process. That does not require programs to be identical or even similar as client fact patterns will vary widely. A completely consistent philosophy will produce widely different programs when applied to those fact patterns. Paraphrasing David Swenson, "Don't do as I do, think as I think."

IV. Performance

Evaluating the performance of any money manager, including a CIO, is both essential and tricky. It should be viewed as a retrospective on decision-making rather than a simple win-lose score card. For example, over the past ten years all managers who specialized in buying large U.S. growth stocks (Amazon, Microsoft, Apple, Netflix) have performed better than the S&P 500, as those stocks have simply been in favor for an unusually long time; the old saw reminds us that even a stopped clock is right twice a day. Conversely, a specialist manager emphasizing the importance of price to cash flow and buying assets below their intrinsic value (a perfectly logical approach) will have underperformed the S&P 500 for the same unusually long period. Both sets of results are more an indication of random style rotation (only predictable through the rear-view mirror) than of manager skill.

The same is true in CIO-space. A philosophy that emphasizes managing risk through the power of broad, global diversification will underperform the S&P 500 when that more concentrated asset outperforms, then outperform when the S&P 500 lags the rest of the world.

Simple performance numbers tell us almost nothing, and no CIO will get every decision right. In fact, just getting more right than wrong, *with consistency,* will land you in the hall of fame. But every decision must be carefully considered and completely aligned with the CIO's chain of compelling logic. The point of ongoing evaluation is to confirm the 4Ps: "Are these people just as honest and insightful as we thought they were; do they truly believe in the compelling *philosophy* that they articulated to us; does the *portfolio* they have constructed reflect that philosophy and does our *performance* reflect decision-making that has been crisp, consistent, insightful and more often right than wrong?"

Conclusion

We serious investors have promises to keep. We promise to provide for our families and support the causes we care for. And, in the words of Robert Service, "A promise made is a debt unpaid." Decades ago, the world's most sophisticated investors concluded that a fully capable, independent investment office maximized their likelihood of fulfilling those promises. OCIO delivers those same indisputable advantages, but only if executed well, through firms that are structured to eliminate conflicts of interest, who have the scale to advocate client interests with real power and who have lived with point-accountable decision-making for decades. According to Charles Skorina, there are 25 OCIO firms fitting that description. Give one a call.

Jonathan J. Hirtle

Jon is the founder and Executive Chairman of Hirtle Callaghan. In 2011 he was dubbed the "Oracle of Outsource" by *Pensions & Investments* as Hirtle Callaghan is best known for its role in pioneering the outsourced CIO (OCIO) model for families and institutions. Jon appears regularly on national broadcast networks including CNBC and Bloomberg Television. Prior to founding Hirtle Callaghan, Jon worked at Goldman Sachs and was an officer in the United States Marine Corps.

HIRTLE, CALLAGHAN & CO.

Hirtle Callaghan was founded in 1988 to serve as an outsourced investment office for institutions and families. We have provided independent investment advice for over 30 years to investors seeking to improve the structure, process and returns of their investment programs. Today, we are a national brand known for its professional, client-centric culture. With each client in mind, we design and manage a complete, custom-designed investment program that is diversified across global opportunities, including public and private markets.

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