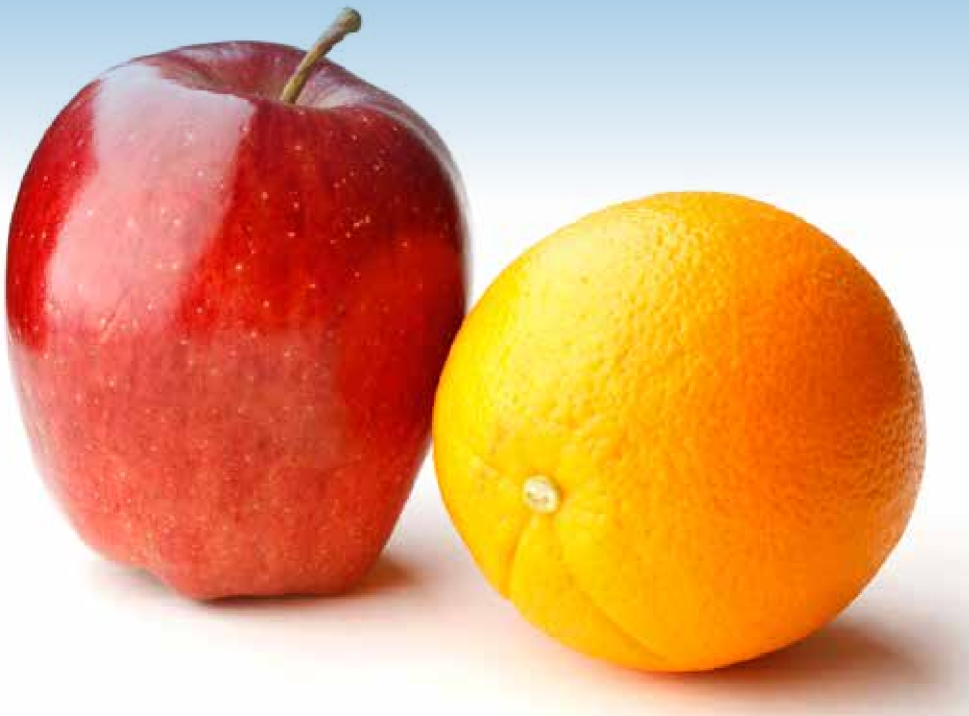
Strategic Investment Group®

CUTTING THROUGH THE CONFUSION IN OCIO FEES

Fiduciary Insights



COMPARING FEE QUOTATIONS OF OCIO FIRMS CAN BE A DAUNTING CHALLENGE BECAUSE OF THE VARIETY OF FEE STRUCTURES USED IN THE OCIO INDUSTRY. This edition of our Fiduciary Insights series shows how potential OCIO clients can make more accurate comparisons between fee estimates.

Introduction

When choosing among several providers of outsourced CIO services, prospective clients often find it hard to make apples-to-apples comparisons of the fees of candidate OCIO firms. The confusion is understandable, since different types and levels of service can all go under the rubric of OCIO. There are many ways to structure OCIO services and the fees attached to them. As no standards exist for OCIO fee presentations, and the industry has seen many new entrants in recent years, a number of different formats have emerged. Not surprisingly, transparency has often been lacking, and the clarity, level of detail, and accuracy of OCIO fee quotations have varied widely. We sympathize with potential clients who face this problem, and offer some suggestions.

Despite the difficulty, understanding OCIO fees is well worth the effort. Both fees and investment returns affect the bottom line of an investment program, but fees can be well estimated and controlled, whereas investment returns are much more subject to market forces. Therefore, fees are an area where an institution can exert its influence with more certainty of effectiveness.

The First Step: Defining the Fees

A useful first step is to define the fees and expenses any institution must pay in managing its assets, whether or not an OCIO provider is used. A basic list of those expenses would include the following items.

- Consulting
- Internal staff
- Back office
- Office space
- Travel
- Legal
- Direct investment management
- Indirect investment management (e.g., commingled funds)
- Brokerage costs
- Other transaction costs (e.g., market impact costs)
- Actuarial costs
- Custody
- Audit and reporting

All of these costs must be borne by the client, firms acting as agents on the client's behalf, or some combination thereof. Note that for some items, such as custody, direct investment management, and audit and reporting, expenses may be incurred at both the total plan and individual manager level.

Although hiring an OCIO firm does add another layer of fees, it should also generate offsetting fee savings, as an OCIO provides services that were previously paid for by the client by another means. In addition, an OCIO often has more buying power than any of its individual clients and an ability to lower fees for other services incurred in managing the investment program. Moreover, an OCIO can bring new resources, expertise, and operational efficiencies to strengthen the current investment program.

Direct vs. Indirect Fees to the OCIO

When evaluating OCIO providers, focus on how each candidate firm structures its fees, distinguishing between fees at different levels of service, such as the OCIO's direct fees as distinct from the underlying manager fees. Be on the lookout for fees that may be flowing indirectly to the OCIO firm. For example, some OCIO firms hire their own affiliated managers, whose fees they share, or whose equity they own. This may be a perfectly legal practice depending on approval, disclosures and type of fiduciary client, but it is also an indirect source of fees, properly viewed as part of the OCIO's total compensation. If not properly disclosed and controlled it can lead into conflicted decisions that detract from performance results.

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When an OCIO firm shares in the fees of the affiliated managers that it hires for its clients, the OCIO firm can afford to quote a lower fee for its services. With the help of indirect fee revenue, it can take a "loss leader" approach to its direct fees, underbidding competitors that do not receive fees from affiliated managers. Ignoring these indirect revenue sources, and their implications for total cost, can render meaningless any fee comparisons against OCIOs that do not allocate to affiliated managers.

Improving the comparability of OCIO fee estimates often requires some persistent digging. Ask for detailed information about affiliated managers and any revenue-sharing arrangements. An OCIO candidate with affiliated managers should be able to disclose the percentage of any affiliated manager's fee that will flow back to the OCIO firm. If this information is not provided, and you know that the candidate owns a percentage share in the affiliate or product offering, assume that the same percentage of the affiliated manager's fee is going to the OCIO firm. The sum of the OCIO's direct fee and all shared affiliate fees is the true "all-in" fee for an OCIO firm.

Like affiliated managers, affiliated service providers may also share their revenues with an OCIO firm. For example, an OCIO business with an associated consulting practice may hire the consultant's own actuarial unit to provide services to a client, with the OCIO firm sharing in the actuarial unit's fees. Likewise, an OCIO firm that is a unit of an investment bank may be able to discount its OCIO fee because the investment bank expects to make up the difference with lucrative investment banking business. A similar pricing strategy may be used by an OCIO firm owned by a custodian bank.

In all of these loss leader examples, low quoted fees for the OCIO business are only part of the overall firm's total remuneration from the relationship. To make such fees comparable with those of an independent firm that focuses exclusively on OCIO work, it is necessary to know the OCIO's direct or imputed share of any affiliated service provider's fees, and then add them to the total. Loss-leader fee arrangements not only require examination of the resulting total cost to the sponsor, but also any conflicts of interest they may engender and then likely drag on investment results.

Fees That Create Conflicts of Interest

Certain fee structures can put an OCIO firm in a position of conflict of interest with a client's goals. To recognize a conflict of interest, one needs to understand how a fee may affect an OCIO firm's discretionary actions. In the loss-leader example, the OCIO firm is incentivized to direct client business to an affiliated manager or service provider that may not be the best available choice.

In another example, some OCIO firms charge a different fee for each asset class they oversee, while exercising discretion over allocation among asset classes. In contrast, OCIO firms that charge a single comprehensive fee that includes all asset classes are free of this conflict of interest.

Another conflict-creating arrangement is an all-inclusive fee structure in which the OCIO firm pays all manager fees out of its own fee. This encourages the OCIO firm to hold down manager fees, even at the expense of potential value-added. Separating OCIO fees from manager fees avoids this conflict.

Manager Fee Estimates: Asset-Based or Performance-Based?

In addition to their own fees, OCIOs are often asked in requests for proposal (RFPs) to estimate their underlying managers' fees. This is another area subject to confusion, partly because of the variety of manager fee structures that exist. Many managers offer an asset-based fee schedule under which the manager charges at a declining rate as assets rise. Estimating such an asset-based fee with reasonable accuracy is easy, as the potential OCIO client's recent asset levels are known. However, a problem arises with managers that offer a base fee plus a performance fee. Since a performance fee depends on future outperformance, of course it cannot be known in advance. In RFPs, some OCIO firms simply ignore the performance portion of the fee structure and include only the base fee without highlighting the absence of the performance fee. This omission often leads to a misleading underestimate of the total manager fee. Close attention to net of fee returns for those asset classes with higher performance fees is a central complement in the analysis.

To make manager fee estimates comparable, request more disclosure and detail, and use the information to make necessary adjustments. In the RFP, require the OCIO candidate to note which kind of fee structure is being assumed for each manager included in a manager fee estimate. Consider also asking that the OCIO candidate estimate performance fees on the basis of expected long-term performance, stating the assumptions used.

Even when manager fee comparisons are fully disclosed, they are only part of the picture, and should never be viewed in isolation. One OCIO firm's managers may have higher fees than another's managers because of higher experienced performance. Not surprisingly, the best-performing managers are often not the cheapest. They tend to command higher fees, in recognition of their value added or limited capacity. Moreover, higher manager fees often reflect an investment policy that emphasizes alternative asset classes. Simply minimizing fees at the expense of alpha is counterproductive. Higher after-fee alpha, not just lower manager fees, should be an OCIO firm's overall objective.

The Service Level Should Match the Fee

As in any bidding process, OCIO fees are quoted for services rendered, so differing levels of service among OCIO firms complicate fee comparisons. Assess the level of service that will be provided for the proposed fee. Accepting the lowest bid may not serve your organization's interests, as you may need enhanced services. For example, consider how much investment experience, access to the senior investment team, and breadth of expertise the OCIO firm will be expected to provide. The lowest quoted fee might not include much more than passive management, or may bring little capability in alternative assets. Some OCIO firms take a cookie-cutter approach to investing, placing all clients in the same commingled products rather than assisting in policy development and customizing their clients' portfolios to fit specific client needs. Junior employees rather than veterans may be used to find and monitor the OCIO's investment managers. The firm might not have a well-developed back office to provide in-depth reports or assist in the year-end audit process. Client education might not be included.

These and all other elements of service can be bundled or unbundled. As there is no standardization yet in the OCIO industry, do not assume that all OCIO candidates are offering the same services, or will deliver them in the same way. To create fair comparisons, ask each OCIO candidate to describe the services that it will provide at the quoted fee level in enough detail to ensure that items important to your organization are included in quoted fees. Talk to the OCIO candidates' clients in reference checks to

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verify that services you are being promised are actually being delivered to them.

Stability and Sustainability are Valuable Offsets to Fees

The fee paid to the OCIO is only the most visible cost of the relationship. The qualitative aspects of the relationship are more likely than fees to determine success.

In comparing costs, do not overlook the cost savings that flow from long-term stability and sustainability. In a sense, an organization's relationship with an OCIO firm is like a marriage—especially so in that divorce can be expensive and painful. The cost of switching to a new OCIO firm can be high in terms of both time and money, as it often means forming several new associations with key people at the new OCIO firm, crafting new investment policies, incurring legal expenses, and then terminating and hiring a roster of managers. Stability in an OCIO relationship flows from a variety of qualitative factors, such as compatible organizational cultures and shared investment philosophies.

Take a broad view of all the ways that hiring an OCIO firm is likely to affect your organization's investment program and its returns for years to come. Partnering with an OCIO firm is a rewarding, but multi-dimensional, engagement. Therefore, it is best to consider all the qualitative factors that will enter into forging a solid, lasting bond with an OCIO, before making a choice. The fee paid to the OCIO is only the most visible cost of the relationship. The qualitative aspects of the relationship are more likely than fees to determine success.

Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., hedge funds, real estate, and/or private equity) or international investments, or manage strategies with high potential for adding value (e.g., portable alpha through investor-friendly turnkey structures). Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

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