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Plan sponsors must think long and hard before outsourcing their portfolio

From fiduciary issues to different models, investment committees have lots to consider

By Sandra A. Urie
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The challenging economic and investment management environment have led more pension, endowment and foundation funds and other plan sponsors to move to outsourcing their entire portfolios.

Changes in the economic environment have created new challenges for the sponsors of pension and other funds as they continue to exercise their role as ultimate bearers of fiduciary responsibility for investment decisions — and outcomes.

Additional resource stresses, including staffing and budget cuts and pressure to diversify portfolios across a wider array of asset classes and strategies, have coincided with a significant move to outsourcing.

In fact, the number of fund sponsors outsourcing their investment portfolios, across a range of providers, has doubled in recent years and is expected to continue. A study by consulting firm Casey Quirk & Associates LLC predicts the investment outsourcing market will grow to $510 billion by 2012, representing 13% of institutional assets and 25% of institutional investors. That projected absolute value is up from $195 billion, representing 6% of institutional assets and 15% of institutional investors, just over a year ago.

The decision to outsource is an important one and should be met with a great deal of thought and careful consideration by fund trustees. Executives should ask a series of questions to determine if outsourcing is an effective approach to oversight of their own investment programs. As part of this process, it is helpful to understand the forces behind the outsourcing trend, and if they apply to an institution's own situation. The trend involves the increasing prominence of alternative assets in institutional portfolios — and the continuum of issues that emerge from these assets, particularly during challenging times.

A look at Cambridge Associates' client base provides a sense of the migration to alternatives: Between 1990 and 2005, the firm's endowment clients' mean asset allocation to traditional equities and bonds decreased by 4.1 percentage points, to 47.6% from 51.7%, and 19.1 percentage points, to 14.2% from 33.3%, respectively. On the other hand, the mean allocation to alternative assets increased by 26.2 percentage points, to 31.4% from 5.2%, to constitute nearly a third of these clients' total portfolios. Needless to say, the shift has added significant asset class, strategy and manager complexity to these institutions' portfolios.

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As a result, many investment committees are realizing that there may be limitations in their oversight approach, especially if it is heavily dependent on infrequent committee meetings. One solution, in addition to hiring additional professional investment staff, has been for institutions to turn to more engaged relationships with consultants and outsourcing providers.

Time well spent

It is our hope that institutions that are thinking about outsourcing will spend significant time and energy exploring a number of considerations to inform their decision — as well as to choose the appropriate model. The considerations include:

Fiduciary fatigue: As mentioned, investment committees have new challenges before them. For many, maintaining current spending in the face of sharp declines is a significant hurdle, as are new valuation methodologies. In some cases, committees conclude they just can't meet frequently enough to position their portfolios in a high-volatility environment and provide sufficient oversight. Committees faced with this "fiduciary fatigue" condition may be likely to consider outsourcing some or all of the investment functions.

Understanding the range of outsourcing options available:

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Outsourcing can take a number of forms but essentially involves the engagement of a consulting or investment firm to assume day-to-day responsibility for asset allocation and implementation, acting in the same capacity as the professional investment staff retained by the largest endowments. The spectrum of outsourcing service models is wide, ranging from fully customized asset allocation and implementation to one-size-fits-all standard portfolios. Some providers of outsourcing services only focus on funds' alternative investments. More specifically, the range of investment outsourcing providers includes: manager-of-managers programs; funds of funds; former CIOs offering a diversified model portfolio; investment managers overseeing a broad-based or balanced mandate; and investment consultants that have been asked to take a more comprehensive oversight role in contrast to a more traditional consulting role. The type of provider that's right for a particular institution can often only be determined after much thought and research — and will depend on the preferences and needs of the institution and its trustees. In some cases, it makes sense for the investment committee and staff to take a very hands-on approach, including being involved in all investment decisions. Other institutions will find it best to delegate almost everything — and just approve the highest-level portfolio policies, such as strategic asset allocation targets.

Asking, and answering, the "some or all" question: When committees get to the point of considering outsourcing, they should ask themselves what is the highest and best use of their own limited time, i.e., what are the critical and necessary areas of focus for the investment committee, and how much do they want to remain involved in making implementation decisions. As previously mentioned, many are choosing to focus on asset allocation strategy and are delegating the implementation and manager selection to others, either their professional investment staff or their outside adviser. There is no one right governance model. Institutions experience many different economic, cultural and social circumstances, as well as geographic and hiring constraints, precluding the prescription of any one approach as a prerequisite to success.

Evaluating the true costs of outsourcing: In thinking about whether to outsource, how to outsource and the level of outsourcing, committees need to keep one principle top of mind: While there may be additional costs involved in choosing to outsource, adding internal resources or both, at the end of the day, it is the assessment of the risk-adjusted return net of fees that matters, not the absolute costs involved in implementing a particular model. The cost of oversight varies with the scale and complexity of the portfolio. There are economies of scale in oversight: While 10 or 20 basis points spent on oversight costs for a very large institutional investor might be prudent, that would be woefully inadequate for a smaller entity. Trends toward increased allocations to alternative assets have created a danger that institutions may actually be spending too little on oversight, rather than too much, since there is a wide dispersion on manager returns, and added resources are required for proper due diligence and oversight of these investments. For example, from Jan. 1, 2000, through Dec. 31, 2009, the difference in performance between the top and median quartile of hedge funds was 228 basis points, while for U.S. venture capital the difference was 764 basis points, and for U.S. private equity the difference was 1,064 basis points. Again, it's critical to evaluate the potential cost of outsourcing in the context of the potential benefits in terms of investment returns and sufficient oversight resources.

Different models, different strengths, weaknesses

Understanding the strengths and limitations of different models: It's important to recognize the true all-in costs, varying lock-up provisions and level of portfolio customization available among the different outsourcing models. As discussed above, some providers offer a single, one-size-fits-all or model portfolio, while others offer some customization at the asset allocation level, implemented through a series of proprietary funds-of-funds or feeder funds. In some cases, there can be long lock-ups and complex transition issues if the institution decides to terminate the adviser. In addition, it's important to understand the level of key-man risk. Does the firm chosen have sufficient depth of talent to continue to serve the institution well if the CIO overseeing the portfolio departs?

Knowing what cannot be delegated: Institutions should take care in understanding the various outsourcing models and which would be the best option in their particular situation, while recognizing that, regardless of the level and scope of services, fiduciary responsibility cannot be delegated. Trustees and their investment committees are the ultimate bearers of fiduciary responsibility for all investment decisions, and trustees should be mindful about selecting an outsourcing provider that can help them fulfill these fiduciary obligations in the most effective way.

At the end of the day, the amount of discretion in investment decision-making that should be given to the outsourcing provider can only be arrived at after a great deal of discussion and review of the many alternatives. In this challenging environment, this is a discussion — along with the question of whether to outsource, hire additional internal staff or maintain status quo — of great importance to every investment committee.

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