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The Journal Interview

Ken Grossfield, CFA
is Chief Administrative Officer and General Counsel of Strategic Investment Group, and is a member of Strategic's Board of Managers. Ken manages the firm's legal affairs, oversees the firm's risk management efforts, which include operational due diligence and investment risk management, and leads the Relationship Management team, focusing on fostering firmwide engagement and standardizing best practices for existing clients. Ken has worked at Strategic for more than twenty years. Prior to joining Strategic, he was an Associate at the law firm of Shearman & Sterling in New York. He has been admitted to the legal bars of New York and the District of Columbia. Ken holds a J.D. from New York University School of Law and a B.A. in Political Science from the University of Michigan. Ken is a member of the CFA Society of Washington, D.C.

Nicole Wellmann Kraus, CFA
is the Managing Director, Global Head of Client Development of Strategic Investment Group. She oversees the development of client relationships and drives the firm's marketing strategy. She also serves as a member of Strategic's Board of Managers. She has more than two decades of experience in the OCIO industry, including nearly a decade at Hirtle, Callaghan & Co. where she worked with the firm's largest clients and ultimately led the institutional practice, and nearly twelve years at SEI Investments working with endowments, pension funds, healthcare organizations, and foundations. She has extensive experience advising investment committees, to whom she is often asked to provide insights on best practices and governance. She has also actively collaborated with the National Association of College and University Business Officers (NACUBO) for nearly a decade, including serving as a speaker at multiple NACUBO events. Nikki is the co-author of Endowment Management for Higher Education, a publication released by the Association of Governing Boards of Universities and Colleges (AGB) in June 2017. She has published various articles in the areas of investment committee governance and investment management. Additionally, Nikki is a frequent guest speaker and skillful moderator of investor panels at industry conferences. Nikki holds a B.A. in English and Computer Applications from the University of Notre Dame. She is a member of the CFA Society of Philadelphia.

Ashley Reeves: Please provide us with some background about yourselves.

Ken Grossfield: I am Chief Administrative Officer and General Counsel at Strategic Investment Group, where I have worked for almost 21 years. A core part of my job is overseeing our risk management, legal and compliance functions, so I have been involved in setting and reviewing our performance presentation and disclosure policies for my entire tenure at the firm. During the early years, prospective client meetings centered around the nature of our "Outsourced Chief Investment Officer" or "OCIO" model relative to the other models that dominated institutional asset management at the time – the consulting model and the bank model. As the OCIO industry has matured, our conversations now focus on how we are differentiated from other OCIOs. This inevitably leads to a greater focus on performance, which is why we feel that achieving uniformity of calculation methodology and presentation standards is critical to an asset owner's OCIO vetting process.

Nikki Kraus: I am Global Head of Client Development at Strategic, and have been in the OCIO space for over 24 years. I have met with as many as 50 investment committees a year for many years, so I believe I am very familiar with the issues and concerns of finance executives and committees as well as their reaction to the concept of an OCIO arrangement, and the concerns they have about it. I have worked in two categories of OCIOs: the multi-product/manager-of-managers OCIOs, like SEI, and the dedicated OCIOs, like Strategic.

AR: Please describe what an OCIO is.

The term "OCIO" has become like the term "hedge fund," meaning that there are many different categories of providers, so one person's concept of what the term

means may be very different from another's. The term obscures the diverse range of service offerings that it is used to describe.

There are a few broad categories of OCIOs, which vary based on the level of discretion, the level of conflicts imbedded in the business model, and the level of customization available to clients.

Dedicated OCIOs, such as Strategic, typically focus solely on OCIO and related services, tend to have a smaller client base, and use a truly open architecture approach, meaning that they do not use proprietary investment strategies. We refer to this as a "conflict-free" business model, because there are no ancillary business lines, and no opportunity for the firm to earn additional fees as a result of its allocation decisions. Therefore, we believe this model best aligns the provider's interests with the interests of its clients. Dedicated OCIOs vary as to the level of customization they offer. Some have a fund with a single asset mix and underlying manager lineup, some have asset class-specific funds and can therefore customize the asset mix but not the manager lineup, and some customize both the asset mix and the manager lineup. Strategic offers all three implementation options, with the optimal choice for each client jointly selected based on client-specific considerations such as portfolio size, liquidity needs, risk tolerance, return objective, legacy investments, and desired governance process.

Other categories of OCIOs include consultants, banks, multi-product/managers-of-managers, and mutual fund complexes. Consultants typically offer three general levels of discretion: "advisory," in which they make recommendations regarding asset allocation and manager selection, but leave the ultimate investment decisions to the asset owner; "implemented consulting," which mixes advisory services and trade execution, often including some level of discretion within prescribed parameters; and true OCIO services, in which the portfolio is managed on a discretionary basis. Consultants charge much lower fees for advisory services than OCIO services, with implemented consulting falling in between. As a result, there are imbedded conflicts, including those relating to the allocation of limited capacity managers across these three business lines. The investment process tends to be decentralized, meaning that each client's performance will be a function of the specific person overseeing its account. These conflicts and issues should be carefully vetted by an asset owner and/or its OCIO search consultant.

Banks have numerous business lines and typically offer a range of investment products, including proprietary strategies for which they collect additional fees. A bank's access to sought-after investment managers may be limited, because managers often compete with certain of the bank's business lines, and therefore may not accept OCIO allocations from them. Again, the potential for conflicts must be reviewed closely.

The OCIO category also includes multi-product/managers-of-managers, and even some mutual fund complexes. Evaluating these models involves some of the same considerations as the consultants and banks. All four of the firm types described above tend to be significantly larger than dedicated OCIOs, both in terms of number of clients and assets under advisement/management. There is also a common belief that they tend to be more focused on asset gathering than delivering superior investment results and service to their clients.

When an asset owner decides to partner with an OCIO, it is typically because the institution does not have sufficient resources or expertise to manage investments directly, especially given the ever increasing complexity of global markets. The job of managing the investment portfolio generally falls either to an investment committee, which typically meets less than ten hours per year, or internal finance personnel, who are also charged with overseeing the operating finances of the organization. In each case, the structure does not typically allow for the focused attention necessary to manage a complex institutional portfolio prudently and efficiently.

On the other hand, committees and CFOs are understandably reluctant to completely cede control of the management of their asset pools to a third party. A common misperception, and one reason we do not like the term "OCIO," is that the investment committee's or CFO's role in overseeing the assets is eliminated when an OCIO is hired. A significant part of the OCIO evaluation process involves getting committee members and executives comfortable that after they hire an OCIO, the committee will continue to map the strategic direction of the investment program, provide critical oversight, and ensure that the institution's long-term interests are served.

The committee can never fully outsource its fiduciary responsibility, so we work collaboratively with the client to focus on the decisions that will have the greatest impact on returns. Most committees would admit that they enjoy picking managers and spend most of their time in committee meetings interviewing and researching managers, but the research is compelling that this structure consistently leads to value detracting selection and timing decisions. It is also not an efficient use of the very limited time that committee members spend together. A single manager search, which may result in a 3% position in the portfolio, may take up an entire quarterly meeting. This does not leave sufficient time for broader discussions that will have a much greater effect on the overall portfolio.

When we work with clients, the committee is extremely engaged in determining the optimal asset allocation based on the organization's return objective and ability to take on risk. Ultimately, the asset allocation of the investment policy is the committee's. The committee also agrees to the allowable asset classes and ranges for each asset class, and sets the liquidity parameters of the portfolio. We work within that framework to seek the best managers and take advantage of top down valuation anomalies. The work of our 40+ member investment team is supplemented by the efforts of a host of risk management, operational due diligence, legal and administrative professionals, which our clients say provide great comfort to them. Our clients also tell us that they could not bear the expense of building a team this comprehensive, with this level of experience and expertise, nor could they support the level of technology and systems infrastructure that we have developed.

AR: Why did you choose to bring your firm into compliance with the GIPS standards?

Clients, potential clients and their OCIO search consultants have expressed tremendous frustration with the games they see and suspect are being played with performance results. They point to a host of abuses, including "cherry-picked" results, the after the fact elimination of accounts that performed poorly, gamed benchmarks, and "simulated," "model," or "backtested" track records. Some of these practices are buried and obscured, while some are more brazen. For example, in 2009, we saw a return history for an OCIO firm that showed, during the 2007-2008 financial crisis, a 40% allocation to a defensive strategy designed to offer significant downside protection. The problem was, the defensive strategy did not actually exist in 2007-2008, and the performance of the strategy was the result of a simulated backtest that was generated with the benefit of hindsight. We have also seen a firm with a seven-year operating history show a ten-year performance record. (While GIPS allows for portability of prior track records in certain instances, it has strict requirements for doing so, which were not met in this instance.) In general, the more product lines a firm has, and the more decentralized its investment process is, the more flexibility it will have to pick and choose the products and client accounts that have performed well to include in its performance presentations. Without some universally accepted ground rules, asset owners and their advisors begin to distrust all performance data, and, by extension, become skeptical of the entire OCIO industry.

We have continually sought to take steps that would increase the transparency of our processes and performance, and the comfort level of our clients and prospects. As an example, for many years we have completed a SOC 1 report on our internal controls. This report, which is not required of OCIOs, helps our clients understand our infrastructure and facilitates their audit processes. GIPS is a natural extension of this philosophy. We have a track record that we are proud of, we believe in transparency, and want to get full credit for the results our team has delivered for clients through many market environments.

AR: What challenges did you encounter along the way?

The process of becoming GIPS compliant is painstaking, exacting, consumes a significant amount of time of many professionals throughout the organization, and is somewhat expensive. There are a number of issues that are more complicated for an OCIO seeking GIPS compliance than for a direct asset manager. These include how to define "discretion," how to group clients into composites in a way that is as inclusive as possible, and how to treat illiquid legacy assets. While these issues need to be carefully considered, they can be addressed in a way that is transparent and workable. After we completed the GIPS compliance process (which took us approximately two years), we received positive feedback from our existing clients, who were encouraged by the fact that it only required us to make very small revisions to our global composite performance results. This validated our belief and our clients' confidence that we were computing these results in a manner consistent with GIPS, even if we had not been claiming compliance with the standards.

AR: Have you found compliance to be beneficial?

Yes. There is a growing number of prospective clients and OCIO search consultants who understand and appreciate the value of GIPS compliance and verification of total portfolio results. We actually won a new relationship because the investment committee knew they could trust the quality of our track record. However, we have been surprised and disappointed by how few people know about GIPS compliance. We are trying to get the word out, and very happy that we have found like-minded OCIO search consultants who are also working hard to encourage and perhaps demand GIPS compliance of all candidates in OCIO searches that they run.

Unfortunately, many OCIO firms take advantage of the fact that few prospects know what GIPS compliance is and they take liberties in presenting their performance histories. Nikki was on a panel years ago and a woman said that OCIO returns are more reflective of the compliance department's flexibility rather than investment skill, meaning that the strength of the returns is based on how much the compliance team allows the sales team to get away with. This can still be true.

AR: Why do you think that so few OCIO firms have moved to GIPS compliance?

We will be direct. Properly measuring and reporting performance results would likely damage the marketing prospects of a number of OCIOs. Very few firms have delivered strong, actual returns across their client base.

Very few firms have a track record as long as the one they are showing potential clients, and many worry about how their hands will be tied going forward. You will continue to hear, "We are working on it," or "We are thinking about it." We think this is often code for, "We don't want to do it." In the direct active manager space, firms need to have a GIPS compliant track record to be considered by industry leading consultants and OCIOs. We believe this should be the same for OCIOs and, again, are happy to say that many OCIO search consultants support this goal.

AR: Do you feel that GIPS should have any special rules for OCIO firms, or are the rules, as written, sufficient?

We have also heard some firms say that they think the GIPS standards need to be loosened or modified for OCIOs. We disagree. We think the guidelines and the verification of total firm results are exactly what prospective clients are seeking.

One challenge that we often hear mentioned is that OCIO services are so customized that it is meaningless to aggregate client portfolios into composites because you would be mixing a range of different asset allocations. While this is true for absolute performance, it is not true for relative performance. Absolute performance is a function of many things – a client's return objective, risk tolerance, liquidity needs, comfort level with various asset classes – that are unrelated to the OCIO's investment skill. Relative performance, that is, how an actual client portfolio performs against an appropriate benchmark selected on an ex-ante basis, is a pure measure of investment skill. Therefore, the performance of a composite of actual client returns, compared to the returns of each client's benchmark, weighted in accordance with the size of each client portfolio, is a meaningful, and we believe the only, way to appropriately gauge the investment success of an OCIO.

While GIPS compliance occurs at the overall firm level, an OCIO has the option to produce either individual asset class-level or total portfolio-level composites. The multi-product/manager-of-managers who have claimed GIPS compliance have typically opted to produce asset class-level composites. When presenting performance to prospects, they then aggregate these asset class composites into hypothetical global portfolios, with the allocations to each asset class selected with the benefit of hindsight. This method does not accurately capture the actual performance that clients experienced, because it ignores the impact of the OCIO's actual asset allocation decisions. Prospective clients should be looking for verification at the total portfolio level to develop confidence in the OCIO's skill in doing the exact thing the prospect is looking to the OCIO to do: manage the total portfolio.

AR: What other thoughts do you have?

As we noted at the beginning, each of us has had the pleasure of working in the OCIO industry for more than two decades. However, the industry as a whole is still in a relatively early stage. The state of OCIO GIPS compliance reminds us of where the direct asset management industry was when we started. Many traditional managers initially resisted GIPS, but, driven by investor and consultant demand, GIPS became industry standard. We are optimistic that the same will happen in the OCIO industry, with insightful asset owners and OCIO search consultants leading the charge.

AR: We greatly appreciate Ken and Nikki sharing their thoughts with us. For those who are wondering, here is the firm's claim of compliance, firm definition, and information on obtaining their list of composite presentations.

Strategic Investment Group® ("Strategic") claims compliance with the Global Investment Performance Standards (GIPS®). Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional investors. Our proprietary process combines active portfolio management, rigorous risk management, and open-architecture manager selection. To receive a compliant presentation and/or the firm's list of composite descriptions, please contact Nikki Kraus at nkraus@strategicgroup.com.

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