WHAT IS THE ROLE OF THE INVESTMENT COMMITTEE WHEN HIRING AN OCIO?

Strategic Investment Group®

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Fiduciary Insights

IN THIS EDITION OF OUR FIDUCIARY INSIGHTS SERIES, WE HIGHLIGHT THE WAYS IN WHICH AN INVESTMENT COMMITTEE'S ABILITY TO PERFORM ITS ESSENTIAL FUNCTIONS IS ENHANCED BY THE ENGAGEMENT OF AN OCIO. An effective fiduciary partnership with an OCIO allows the Committee to extricate itself from second order tasks and refocus its energies on strategy, policy setting, and oversight.

Learn More

To learn more about us and download our **Fiduciary Insights** series, which is dedicated to issues relevant to fiduciary best practices and responsibilities, please go to strategicgroup.com/our-thinking/research and publications. Topics include, "***The Art and Science of Manager Termination***", "***Developing a Culture of Good Governance: A Committee Self-Evaluation***", "**Common Symptoms of Poor Governance**", "***Understanding Fees***", and "***Does Outsourcing Mean I Lose Control?***".

Introduction

Investment Committee members often ask us, "How will the role of the Investment Committee change when we hire an outsourced CIO to act as our co-fiduciary?" Our response is straightforward: "The committee's primary role is unchanged. The committee continues to map the strategic direction of investments, provide critical oversight, and ensure that the long-term interests of the institution are served. Indeed, it is our experience that the committee's ability to perform its essential role is enhanced by extricating itself from second order tasks and refocusing its energies on strategy, policy setting, and oversight."

The main role of an Investment Committee is to set the strategic policy direction for investments, select agents to implement that policy on its behalf, and ensure that the agents selected adhere to agreed guidelines and targets. This essential role remains unchanged whether or not an OCIO is selected as a co-fiduciary.

This edition of Strategic's Fiduciary Insights series sets out the rationale for our response. To put our response in context, we begin by briefly describing the role of the Investment Committee in the investment governance structure. We next consider why Investment Committees choose an OCIO as a co-fiduciary partner. We conclude by describing how the OCIO fits in the overall investment governance structure established by the Committee, highlighting what changes and what remains constant.

Role Of The Investment Committee

Investment Committees bear a heavy fiduciary responsibility in serving as good stewards for the institution's investment assets. Ensuring that those assets are allocated in a way that supports the long run ability of the institution to achieve its mission is at the heart of the Committee's fiduciary responsibility. Fulfilling this responsibility requires the Investment Committee to remain abreast of developments in the finances and operations of the institution and adjust the strategic objectives and risk profile of investment policy accordingly. With the long-run objectives of the institution uppermost in mind, the Committee sets the strategic direction for investments, approves the investment policies that guide all investment activities, establishes risk parameters, and supervises the implementation of the policies and risk guidelines that the Committee has established.

The Committee also serves as an important sounding board and provides support to the internal investment team and, when necessary, provides an important check and balance in the governance framework. In performing these essential functions, the Committee should never stray into the area of management and execution. Becoming entangled in day-to-day management will distract the Committee from its primary role of setting the strategic policy direction for investments and ensuring adherence to the guidelines it has established. Moreover, an active involvement in day-to-day portfolio management undercuts the Committee's ability to serve as an independent check and balance in the investment governance structure.

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The Decision To Outsource

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- **Enhanced Performance Targets.** The ultimate aim for fiduciaries is to achieve or exceed their return objective at the least cost and with the minimum amount of risk. A disciplined investment approach supported by sophisticated analytical tools provided by the OCIO can enhance the likelihood of sustaining strong risk-adjusted returns. Moreover, such a disciplined and rigorous approach can help avoid the common pitfalls of investment management, including return chasing and manager churn.
- **Streamlined Governance.** An OCIO increases the efficiency of decision-making, simplifies oversight, and helps appropriately focus the attention of each level of investment governance. By taking on the responsibility of the day-to-day management of the investment portfolio, the OCIO reduces the number of agents that need to be monitored by the Investment Committee, and allows the Committee to focus on setting the institution's strategic direction and ensuring the alignment of the investment policy with that direction
- **Expanded Resources.** Managing complex investment portfolios is rarely a core competency of institutions reliant on such portfolios to support their missions. The broad range of resources required for the task is typically not available in-house because it is neither cost-effective nor practical to build and maintain such an internal capacity. An OCIO provides the diverse resources and capabilities needed to manage complex investment portfolios efficiently and effectively.

The Investment Committee and the OCIO

Changes

While the essential role of the Investment Committee does not change with the engagement of an OCIO to act as a co-fiduciary, some of its activities will be transformed for the better. The main change is that the Investment Committee will no longer be involved in directing the hiring and firing of managers and tactical asset allocation changes. In our experience, having the Investment Committee take a step back from the decision to hire and fire managers and make tactical asset allocation decisions improves investment governance and performance.

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Investment governance is enhanced by the engagement of an OCIO acting as a co-fiduciary partner because this transition allows the Investment Committee to focus on strategic considerations. The traditional approach that relies on the Investment Committee to make operational decisions leads to a fragmented governance structure. In this structure, the Investment Committee must select and continuously monitor a large number of managers across asset classes as well as other agents, such as consultants and operational due diligence specialists, that the Investment Committee relies on for its decisions.

This approach does not play to the Investment Committee's strengths. Few Investment Committees have the breadth of technical expertise spanning assets and strategies, analytical resources, and time to adequately vet and continuously monitor agents managing segments of the investment portfolio. Often, Investment Committees look to consultants to provide the missing expertise and resources. A consultant-led process puts most of the control of selecting a manager in the hands of the consultant and all of the responsibility for the decision in the hands of the Investment Committee. In this approach, the consultant typically presents a few finalists that fit the bill (often selected on the basis of strong recent returns) in a process that is like a beauty contest in which the Investment Committee has only a superficial impression of the managers gleaned in a brief presentation.

Besides leading to a fragmented approach to decision making, this approach often leads to sub-par returns. The most comprehensive analysis of institutional investors' manager selection decisions is a 2008 Journal of Finance article by Amit Goyal and Sunil Wahal, "The Selection and Termination of Investment Management Firms by Plan Sponsors." The study revealed a consistent tendency to chase returns, leading to subpar performance. Managers were hired after a period of outperformance to replace others who had recently underperformed. Comparing the returns of fired managers with those hired to replace them, the study found that the average manager transition destroyed significant value (1.4% annualized underperformance of the hired manager versus the fired manager over the subsequent 3 years). Other studies of the track record of institutional investors' tactical asset allocation decisions have found similar results.

Constants

As noted previously, the engagement of an OCIO to serve as a co-fiduciary has no impact on the essential functions of the Investment Committee. We briefly consider the most important of these unchanging constants in Investment Committee responsibilities.

Strategic Asset Allocation Policy

Ensuring the alignment of the expected risk and return of a portfolio with the long run financing needs of the institution is the ultimate objective of every Investment Committee. Achieving this objective requires thorough understanding of how the portfolio fits in the broader finances of the institution, as well as likely changes in the circumstances and strategic direction of the institution that may affect its return requirements, liquidity needs, and ability to bear risk. In addition to establishing the strategic asset allocation, the Investment Committee must also consider the acceptable range of different types of risk and establish risk parameters and operational guidelines designed to ensure the observance of the investment policies established by the Committee.

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Implementation Model

Having set the strategic direction for investments, the Investment Committee must determine how to implement that strategy. The framework guiding how investments are to be managed is set out in an Investment Policy Statement (IPS) approved by the Investment Committee. In addition to specifying the strategic asset allocation policy and risk parameters just described, the IPS sets out the investment governance framework, including the roles and responsibilities of various principals and agents, performance benchmarks, and lines of accountability.

Ongoing Monitoring

With the strategic direction and governance framework of the investment program well defined, the Investment Committee must establish procedures of monitoring the performance of the portfolio and the adherence to guidelines and risk parameters. The Investment Committee must also monitor the level of fees and costs of the investment program to ensure that these fees are appropriate and commensurate with expected value added.

Regular Strategy Reviews

Although a strategic asset allocation decision is designed for the long term, such policies are rarely static. Most often, changes are necessitated as a result of the changing circumstances and strategic direction of the institution. A key role of the Investment Committee is to remain aware of such changes and adapt the strategic asset allocation policy and risk parameters accordingly. This requires close coordination with the institution's other leaders and stakeholders.

Outreach to Stakeholders

The Investment Committee also plays a pivotal role in helping to develop the message for the institution's investment approach with all constituents and stakeholders, other board members, and senior management.

Conclusion

Attempting to control each of the multitude of tasks—big and small—inherent in managing complex investment portfolios often results in losing control of the essential big picture, leading to a fragmented investment governance structure and subpar returns. Instead of focusing on finding the right mix of assets and strategies to support the mission and broader operations and finances of the sponsoring institution, limited internal resources and governance bandwidth are consumed by second order tasks. A strong partnership with a co-fiduciary can reorient the focus of investment governance on key strategic issues and strengthen the effectiveness of investment oversight. With the right co-fiduciary partner, the Investment Committee can focus on fulfilling its essential role in the governance structure and better meet its fiduciary responsibility.

Ultimately, the Investment Committee plays a paramount role in the financial health of the organization it serves, directly affecting its ability to fulfill its mission. Engaging an OCIO to implement the investment program expands the resources available to the Investment Committee and staff to fulfill their important fiduciary responsibilities of sustaining the institution's long-run financial strength.

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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 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 missions, 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.

For more information, please email us at inquiries@strategicgroup.com.

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