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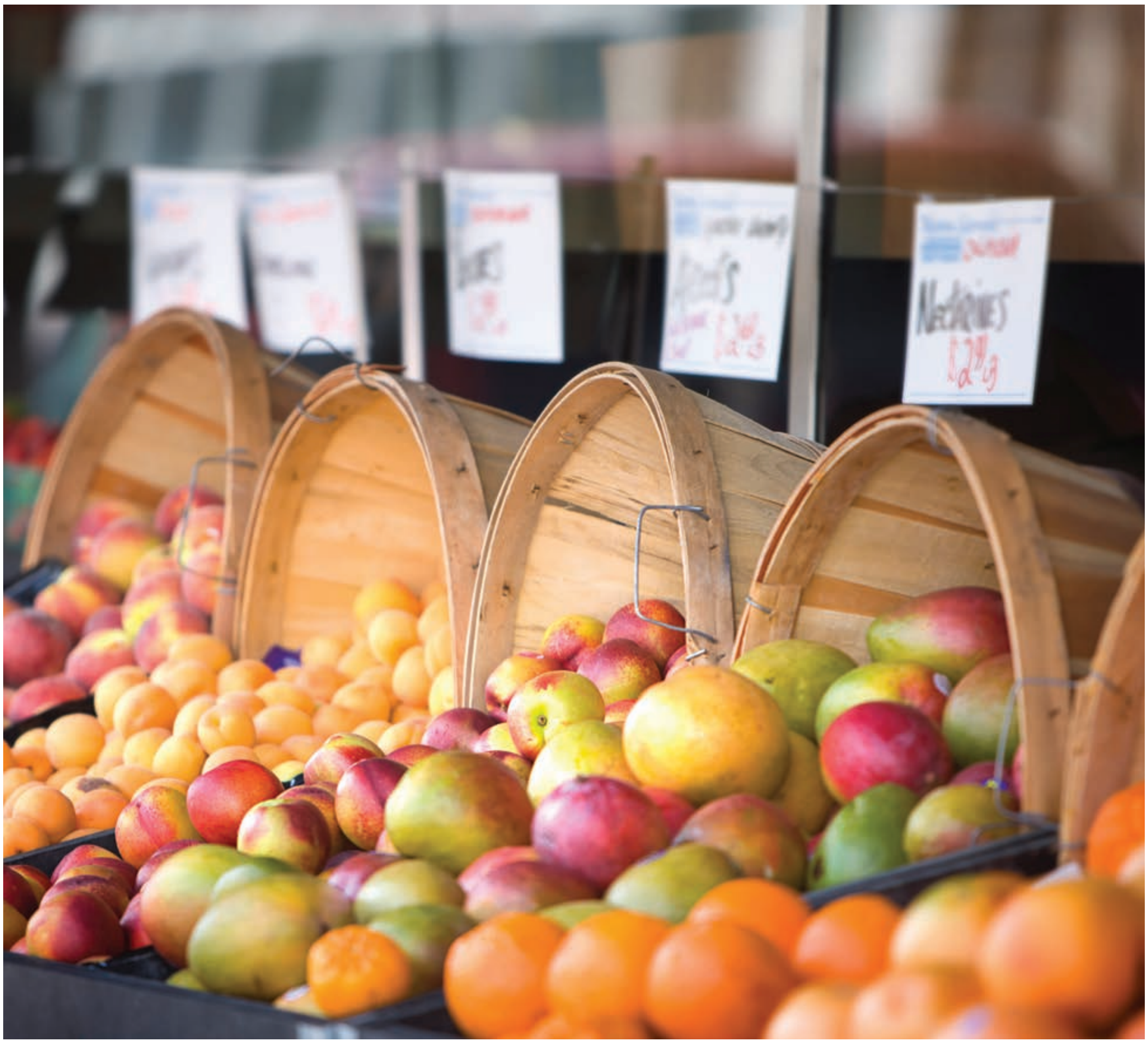
# of apples, oranges and onions:



assessing OCIO performance and fees

Nearly all CFOs and investment committees consider it. And more than ever are acting upon it: investigating the possibility of an Outsourced CIO (OCIO) to manage their institution's investments.

When assessing potential OCIO providers, institutions typically first cover two "essential Ps" —the providers' People and Processes. But once that due diligence is completed and the evaluation process enters the final stretch (that is, the waning pages of an RFP), it comes down to two more Ps that are just as critical: Performance and Price. And this is where the reporting can get a little muddy.

The reason: While OCIO providers' people and processes are relatively easy to compare and contrast to determine their value, performance and price are areas where such simple and direct comparisons are more difficult to make. Neither of these categories lends itself to a simple check-the-box evaluation. Rather, drawing comparisons is a complex apples-to-oranges exercise, because there are so many variables to consider in each of those categories.

Complex, but not impossible: Here are some criteria for comparing the price and performance of OCIO candidates.

Performance

The challenge in determining an OCIO's performance begins with the question of how exactly one wishes to define the term. Is performance return? Is it return within a given risk profile? Is it risk-adjusted?

The fact is, today there is no standardized way to define performance. And if it cannot be singularly and consistently defined, how can it be measured and compared to other providers?

ONE SIZE FITS ALL?

Given the multiple variables involved in assembling an institution's investment portfolio, there really is only one simple way that a direct comparison could be made of OCIO performance—that is if portfolio construction were of the one-size-fits-all variety, in which all institutions invest in the same vehicles in the same percentages.

Some OCIOs do indeed employ this "single fund provider" model. The vast majority of OCIOs, however, go the other way, employing a customized approach to assembling a portfolio for each of its institutional clients. They tailor asset allocation to the individual organization's unique investment policy, objectives and strategy. In this customized portfolio realm, direct performance comparisons are not only nearly impossible to draw, but also—given the inconsistencies in construction —virtually meaningless to attempt.

Consider that the OCIO process begins with understanding the purpose of the institution and its fund(s), which leads to a desired set of risk/return guidelines that govern portfolio construction. Under this process, performance is simply an outcome. And, by definition, performance outcomes are as unique as the institutions themselves and should not be compared casually.

Let's back up for a moment and recognize that the reason there is no such thing as a standard definition of performance is that there is no such thing as a standard portfolio construction. After all, the components and allocation of a portfolio are unique to an organization's requirements, its investment policies and objectives, and other considerations. So, if organization A's needs and mandates dictate a more conservative

TIPS FOR COMPARING OCIO PERFORMANCE

Intent on attempting a side-by-side comparison of OCIO performance? Consider these tips.

- Ask all OCIOs to show the percentage of their clients that beat their custom benchmarks, after fees, over standardized time periods (e.g., 1, 3, 5 and 10 years).
- Always ask for net, not gross, returns; similarly, always ask for actual, not back-tested, performance.
- Be sure OCIOs include all client portfolio results, rather than a cherry-picked few, in their historical performance.
- Get a breakdown of OCIOs' historical average return by institution size, as well as by asset class as seen in this example from the most recent NACUBO-Commonfund Study of Endowments® (NCSE):

Average Net Return by Asset Class for Fiscal Year Ended June 30, 2013

numbers in percent (%)	Total Institutions	Assets Over $1 Billion	$501 Million–$1 Billion	$101–$500 Million	$51–$100 Million	$25–$50 Million	Under $25 Million
	835	82	70	261	166	125	131
Average FY2013 total return	11.7	11.7	12.0	11.9	11.5	11.4	11.7
Domestic equities	20.6	21.3	21.5	20.7	20.3	19.2	20.6
Fixed income	1.7	1.4	0.5	1.7	2.0	2.3	1.9
International equities	14.6	14.9	15.6	14.4	14.7	14.9	13.1
Alternative strategies	8.3	10.6	11.0	9.1	7.4	6.5	4.8
Private equity (LBOs, mezzanine, M&A funds and international private equity)	9.1	12.5	9.8	7.3	8.9	11.8	*
Marketable alternative strategies (hedge funds, absolute return, market neutral, long/short, 130/30, event-driven and derivatives)	10.5	11.9	13.1	10.5	9.9	8.2	8.2
Venture capital	6.1	9.7	3.6	5.4	3.9	*	*
Private equity real estate (non-campus)	8.5	8.8	9.9	9.6	4.6	8.1	*
Energy and natural resources	4.7	5.5	6.8	3.9	3.8	0.3	*
Commodities and managed futures	-6.1	-8.3	-6.1	-6.7	-5.0	-4.3	-6.4
Distressed debt	14.8	18.0	17.8	12.9	13.3	*	*
Short-term securities/cash/other	1.2	0.8	0.9	1.8	0.7	0.7	1.2
Short-term securities/cash	0.3	0.6	0.2	0.4	0.2	0.4	0.1
Other	5.3	*	*	6.0	3.0	*	5.9

*sample size too small to analyze

Source: NACUBO—Communfund Study of Endowments, 2013

portfolio mix, and organization B's needs and mandates dictate a more aggressive allocation, the performance of those portfolios should not be compared.

Peel that onion a little further, and one uncovers still more variables. Consider, for example, an institution's investment mandate. An endowment may establish, say, a 4.5 percent real (i.e., after inflation and fees) return benchmark, while a foundation may establish one of 5.5 percent real. Two different types of institutions, two different goals, two different portfolios.

Another layer: An institution may dictate constraints and prohibitions on its investments (for instance, no hedge funds, no tobacco, no alcohol, etc.), while another may not. Again, two sets of rules that result in two different portfolios.

Given the above differences in portfolio construction, attempting to compare performance is like trying to keep score of a game in which the teams are playing on two different fields.

Price

Many institutions conducting an OCIO search will claim price doesn't matter. But everyone knows that it does. And the fact that it doesn't appear until the last few pages of an RFP belies the weight that fees ultimately carry in the decision-making process. Fees are rarely noted in surveys as being among the most important criteria in OCIO selection, but committee decisions often cite cost as a key deciding factor.

It's a simple enough question: "What are your fees?" The answer isn't quite so simple, or even as quantitative. In fact, when asked what it costs to manage their portfolios, few institutions can actually cite a hard and fast number.

OCIO fees are determined by many of the same client considerations that drive performance differences: client type and size; investment committee mandates and objectives; governance models; and investment strategies and asset allocations. For example, active (vs. passive) management and/or investing in separate accounts, commingled funds or partnerships may increase fees. And institutions may be willing to pay more for OCIOs' fiduciary responsibility and operational expertise.

PARSING FEES

Here are the most common external fees that an institution incurs in its investment management costs:

Portfolio construction and management

Direct investment and management fees[1,2]

Carry/incentive fees[2]

Activity and transaction-related fees

Trading and brokerage costs[2]

Prime brokerage fees[2]

Custody fees[1,2]

Administrative oversight

Audit fees[1,2]

Legal fees[1,2]

Administrator fees[1,2]

1 Generally included in investment cost
2 Generally netted against returns

Fees vs. costs

One challenge in determining total outlay for investment management is, frankly, defining one's terms, as in fees paid vs. total costs. In a recent Commonfund survey, most institutions could only offer estimates of their investment management costs—ranging from 64 to 80 basis points. However, those numbers failed to account for ancillary fees such as custody, legal and other costs (see the sidebar above). Once those are factored in, the actual total cost easily exceeds 100 bps and can approach 170 bps.

Cost of Managing Investment Programs for Fiscal Year 2013

	Total Institutions	Assets Over $1 Billion	$501 Million–$1 Billion	$101–$500 Million	$51–$100 Million	$25–$50 Million	Under $25 Million
Responding institutions	710	46	54	231	155	111	113
Average cost ($ in thousands)	1,707	15,130	4,681	1,395	374	189	85
Average cost (basis points)	64	74	74	70	55	57	61
Median cost (basis points)	52	50	52	58	48	45	56

Source: NACUBO—Communfund Study of Endowments, 2013

WHICH FEES INSTITUTIONS INCLUDE IN THEIR COST CALCULATIONS

Included in Cost Calculations*

numbers in percent (%)	Total Institutions	Assets Over $1 Billion	$501 Million–$1 Billion	$101–$500 Million	$51–$100 Million	$25–$50 Million	Under $25 Million
Responding institutions	662	47	55	217	141	100	102
Asset management fees and mutual fund expenses	86	83	85	90	85	83	81
Direct expenses	55	81	91	67	48	34	28
Incentive/performance fees paid to asset managers	15	38	35	18	9	7	2
Internal staff	20	79	56	21	7	2	6
Consultant/outsourcing fees	66	72	95	81	63	41	42
Other	11	28	20	12	7	6	4

*multiple responses allowed

Source: NACUBO—Communfund Study of Endowments, 2013

Extending this concept into the OCIO realm, a key factor that makes fee comparisons challenging is that, often, institutions evaluating OCIOs confuse fees paid with total costs. When an institution asks an OCIO "What are your fees?" and the response is, say, 35 basis points, some investment committees may be taken somewhat aback—especially when the number is compared with a consultant's typical base fee of 10 basis points plus travel.

Again, though, just as in the performance realm, it's an apples-and-oranges comparison. And when a few important considerations are taken into account, institutions typically find that the "10 vs. 35" comparison is an invalid measure.

Note that an institution pays all these external fees whether they use a consultant or an OCIO. If one were to list out consultants' and OCIOs' fees in similar fashion, their respective total costs would actually be quite similar.

An important step to take, then, in evaluating and comparing fees is to separate the OCIO's own fee from other underlying charges. (Note: An OCIO that values transparency will be able to parse fees for you.) Only when that is accomplished can an institution accurately measure and compare fees.

Added value

Another important consideration in comparing fees is understanding an OCIO's additional duties and resulting value.

Let's say that an OCIO offers more than just investment advice, and expands its expertise to more holistic financial guidance. That OCIO should be viewed as providing sizable added value and be compensated accordingly. In addition, if that OCIO provides back-office duties (which, incidentally, consultants generally do not provide), a higher fee is similarly warranted. Also, if the OCIO is taking on the responsibilities of an in-house, full-time employee(s)—reconciling books, managing cap calls/distributions, etc.—it's important to account for the cost savings of that employee(s) in fee calculations and comparisons.

Different fee models

A third important consideration in comparing fees is the same lack of standardization found in performance metrics. There are several different types of fee models in the OCIO realm, and it's important to peel the onion (again) in order to decipher them. Among the options: "flat fee" and the "flat-fee-plus-incentive/carry."

In evaluating OCIOs, keep in mind that assessing performance is not a simple check-the-box exercise.

While the flat fee model is self-explanatory, the flat-fee-plus-incentive/carry model entails a number of variables that muddy the comparison waters. Among those variables: benchmarks, time frames (over what time frame will the incentive be calculated?), and percentage of "clawback," or fees refunded due to unique circumstances.

The flat-fee-plus-incentive/carry model has proven to be controversial over the years. Some institutions embrace it, believing that it incents higher performance from their OCIOs. Other institutions are less sanguine, contending that a fee-plus-incentive structure incentivizes the OCIO to take greater, potentially inappropriate risks in pursuit of the benchmarks that earn them performance bonuses.

Not just checking boxes

At first blush, performance and price may seem straightforward, quantitative measures. But they are far from simple matrices. In evaluating OCIOs, keep in mind that assessing performance and fees is not a check-the-box exercise. History has shown that it actually takes more time and effort to decipher these two seemingly quantitative categories than the qualitative ones, such as people and processes.

The CFO and investment committee need to consider and understand fees and performance in the right way, in both upfront selection process and on an ongoing basis, in order to make a prudent OCIO selection.

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