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MILESTONE GROUP'S PAUL ROBERTS DISCUSSES THE OUTSOURCED CIO MODEL AND EXPLAINS HOW OPERATIONAL PRESSURES CAN BE RELIEVED.

Can you explain the outsourced CIO model?

The outsourced CIO (OCIO) model is where trustees, plan sponsors, foundations and endowments choose to delegate their investment management decision-making duties to experienced asset managers or investment consultants.

Under this model the fiduciary responsibility for managing the asset allocation and selection of investment managers is transferred to the outsourced CIO provider. In some markets this activity is referred to as fiduciary management or delegated investment management services.

What is behind the growth of this market?

There are several factors that have driven the growth of the OCIO market. A key driver to date has been the recognition by asset owners, who are the clients of an OCIO, that they may not have the ideal critical mass or all of the required skills to effectively deal with expanding asset class coverage and investment complexity. This has given rise to selecting OCIO providers to access expertise in highly specialised markets such as private equity, private debt, limited partnerships and highly structured investment vehicles as part of the overall asset allocation model. Another factor is agility. OCIO firms can more quickly undertake decision-making in response to market conditions that otherwise, through a traditional in-house chief investment officer and investment committee model, might not be practical.

What are the benefits that an OCIO should provide for a firm?

There can be real benefits to adopting the outsourced CIO model, an important benefit being that OCIOs offer expertise for asset allocation and asset/liability strategies that draw upon the provider's intellectual property, as represented by their investment process; in a nutshell, providing a more customised solution to the issue of matching risk with the investor requirements and bringing other operational business benefits as a bonus. These benefits include access to scale, both the operational scale, including reporting and analytics; as well as investment scale in terms of accessing quality and conducting due diligence of available manager investments.

> "ONE IMPORTANT BENEFIT IS PROVIDING A MORE CUSTOMISED SOLUTION TO THE ISSUE OF MATCHING RISK WITH THE INVESTOR'S REQUIREMENTS."

What are some of the challenges involved for OCIOs?

Today the OCIOs find themselves with a number of challenges. The first challenge most OCIOs recognise is that as they grow their client base, their own investment operations teams come under a greater level of pressure to scale and support the business. The challenge is not just around resources and reducing pressure on the operations team but rather around the issue of fiduciary duty and the purpose of the OCIO in terms of their role. The purpose of an OCIO is to undertake a fiduciary asset management function on behalf of their clients and, therefore, it stands to reason that the long-term risks associated with limitations of manual processes and less automated controls becomes untenable as the business scales. As the business scales, the operational risk associated with placement and acknowledgement of trades increases, and an error can have a direct impact on the OCIO service delivery to the client, quality of service perception, performance, and costs in remediation.

The second challenge is the competitive landscape; as OCIOs are fiercely competing for business, the ability to demonstrate a robust and repeatable investment process supported by appropriate technology becomes more critical. The issue here is that most front-office investment technology has been designed for direct asset trading in highly liquid markets but has not been designed for pooled product fund trading, which has different exposure liquidity, placement, and settlement characteristics. This means that as the OCIO competes for clients requiring more complex investment management strategies, these traditional investment technologies will not be able to service these firms. We are observing, today, OCIOs who have previously adopted 'traditional investment technologies', rather than OCIO specific solutions, are now revisiting their systems strategy and upgrading to 'built for purpose' OCIO technology to overcome these limitations.

Have many OCIOs started their business with a model that is not sufficiently future-proofed or scalable?
Our observations are that many OCIOs start small and, typically, their technology is largely built around in-house built systems, spreadsheets and personal productivity tools and as such is a limitation to scale. The issue here is not that these firms don't recognise that they will need to change their model but the point at which change becomes absolutely necessary is at the very point where you don't want it to occur: when new clients are on board, or coming on board, and you have real capacity challenges.

What should OCIOs be doing to address these issues? What is a more sustainable technology/operating model for an OCIO?
Fundamental to address these scalability and growth issues is recognising what is important to your business in terms of your investment process. Is it handling high complexity in your asset allocation model, that is you require the ability to implement highly bespoke investment strategies for individual clients; or is it that your model is to operate highly standardised investment strategies across your entire client base? These differences in business models, and degree of complexity in asset allocation implementation, force different operational requirements and in setting your technology strategy, this factor becomes the most critical influence.

Another issue is the design of your operating model around exception management. It is 100% feasible that you can implement an operating model with the right technology that will allow for substantial increases in client volumes while constraining headcount and operational cost. This is important because it goes directly towards margins and competitive positioning of the OCIO.

Finally, and importantly, is recognising what a complete solution should be able to accommodate. What we mean by this is that you should ensure that your operational and technology strategy fully spans and integrates all stakeholder groups within the business. That is: the portfolio management requirements for asset allocation model design and implementation; the investment committee requirements for decision sign-off and trade authorisation; and the investment operations requirements for managing placement, acknowledgements and settlements across multiple managers, multiple custodians and handling multiple data providers.

In summary, the outsourced CIO market is a buoyant one that is experiencing strong competition and operational constraints. Overcoming these constraints can be achieved through rethinking the overall operational and technology strategy and implementing solutions to give the agility and scalability desired.

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IN DEMAND - Paul Roberts says several key factors have driven the growth of the OCIO market