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OCIO Fee Structures — Five Questions to Ask An Outsourced Investment Provider

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Over the past decade, fee compression has been a steady trend in the asset management industry, as competing firms seek to win market share and increase scale.[1] Outsourced CIO services are no exception. When evaluating a potential OCIO provider, fees are important. At the same time, it's crucial to consider fees within a broader context when engaging an OCIO provider. An OCIO relationship is not a commodity. While some providers may offer only strategic advice for a base-level fee, OCIO relationships can deliver a significant premium through a wider and deeper range of services with varying levels of discretion. Here are five questions to ask your outsourced investment provider to help ensure that you get the outcomes you need and expect for the fees you pay.

1. What level of fiduciary responsibility is being offloaded and what is being retained?

Many providers can take on as much — or as little — discretion as a client wishes to delegate. The level of discretion that the OCIO assumes, and plan-related services provided, are reflected in the advisory fee. When determining the decision-making authority that will be assumed by the OCIO, it is also important to consider the scope of plan services the sponsor is able to offload in addition to delegated decision making. Advisory fees are an explicit contractual arrangement and often increase for greater level of delegated services.

When comparing similar delegated models it is also important to consider potential opportunity cost factors caused by inefficient trading and rebalancing services that can erode portfolio values. These include transactional drag, being out of the market, and ineffective rebalancing processes. Each of these factors could supersede a 10 basis point advisory fee, for example, in any *one week*, let alone for a year.

2. What trading infrastructure and risk systems are used to manage and monitor client portfolios?

OCIO providers often use sophisticated tools to handle portfolio management (including trading and rebalancing) and to effectively analyze, manage and report on risk. The most effective trading infrastructure and risk systems are very expensive platforms on a standalone, per client basis. Providers that offer these tools tend to fall in the higher range for advisory fees. As a plan sponsor, you can benefit not just from the skillful practitioners that some OCIO teams offer, but also benefit from their access to these platforms far more cheaply than building or buying them yourself.

Pension risk management often requires different systems for the various lens for which to view risk. The systems are best when used together. Some are stronger on the asset side, while others offer more robust liability reporting. An OCIO harmonizes and interprets these beyond the input assumptions. Grounded, experiential learning to interpret what those assumptions might look like in terms of correlation and outcomes is key to using these tools to gain focus on the most impactful risk factors for your assets. Most institutional clients don't have access to these information sources, so the cost to benefit ratio must be considered.

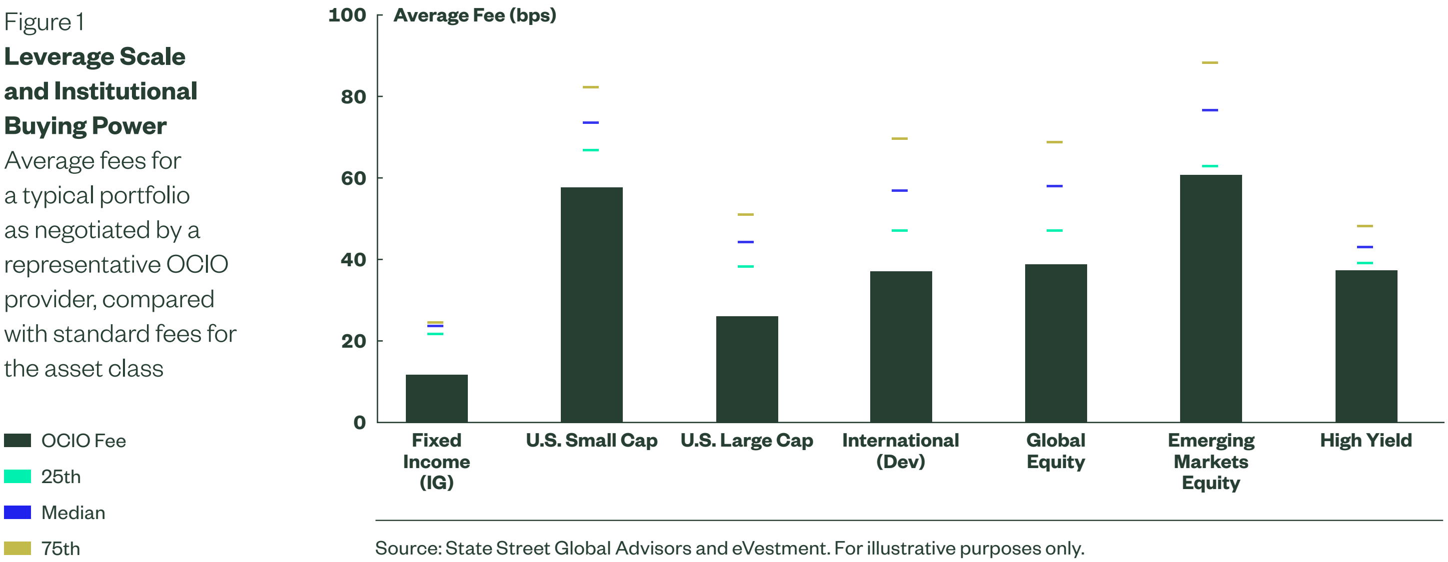
An OCIO with a centralized trading and implementation function that is responsible for managing cash flows, portfolio rebalancing and tactical positioning, executing hedges and overlays, and ensuring timely movements of capital using a consistent approach not only reduces potential transaction cost, but also improves governance related to portfolio actions for approved investment decisions. Providers that offer these enhanced service levels are likely to be on the higher end of the fee range, and rightfully so. It's critical to keep in mind that adverse trading costs or operational errors can more than offset fee differentials among OCIO providers.

3. Does the OCIO have the negotiating power to lower overall portfolio fees?

One of the key benefits of partnering with an OCIO — especially an OCIO with exceptional scale — is the potential to gain cost savings by leveraging the buying power of the provider and the know-how of its manager research function to negotiate reduced management fees for best-in-class investment strategies and vehicles.

The cost savings passed along to defined benefit plans, operating funds, endowment and foundations can be significant and should be considered when comparing OCIOs (see Figure); however, the cost savings passed along to defined contribution (DC) plan participants may actually benefit plan sponsors most. As ERISA law matures and plaintiff-side attorneys gain access to new tools and databases, class action lawsuits claiming excessive 401k plan fees experienced a fivefold increase[2] between 2019 and 2020. The cost savings that an OCIO with a manager research function can generate for DC plan participants can help to reduce the rising risk of litigation.

Figure 1
Leverage Scale and Institutional Buying Power
Average fees for a typical portfolio as negotiated by a representative OCIO provider, compared with standard fees for the asset class



Source: State Street Global Advisors and eVestment. For illustrative purposes only.
Fees shown are averages using December 31, 2020 AUM and existing fee schedules. Percentiles from eVestment universes based on average mandate size and using December 31, 2020 fee schedules published by the investment managers. eVestment universes: Long Duration Fixed Income, US Small Cap Equity, US Large Cap Equity, All EAFE Equity, All Global Equity, Global Emerging Markets Equity, US High Yield Fixed Income.

4. What type of reporting can I expect?

Standard reports providing baseline information from the custodian, such as portfolio values, performance, and attribution, are sufficient for some OCIO clients. Custom reporting typically involves additional costs for OCIO mandates. Some situations — multiple accounts, unique benchmarks, liability and funded status monitoring for pension plans, and/or portfolios with private market investments — require custom reporting. In other cases, clients seek custom reporting because it can yield markedly improved outcomes. Custom reporting on risk assessment through an appropriate risk dashboard can be particularly helpful, because it enhances overall governance and fiduciary oversight.

Not all custom reporting is created equal. Quality custom reporting should not be mistaken for overcomplicated risk reports with a range of outcomes, simulations and back tests. These can ultimately overwhelm and distract clients from what matters most. Custom reporting worth paying for yields insight, allowing you to quickly and easily understand the possible outcomes and what may require some adjustment. Risk assessments should summarize this range of outcomes, highlight where the most significant risks are coming from, and make clear whether any segment of the portfolio may not perform in line with expectations in an abnormal market event. Providing the right amount of data to a client and reducing the risk of surprising the investment committee and senior management is key to a successful OCIO relationship.

5. Am I overpaying for OCIO services?

For plan sponsors already engaged in an OCIO relationship, regular review and consideration of fee arrangements can be helpful. Some client segments haven't benefited from the fee compression trends that have prevailed among OCIO providers in recent years. Institutions such as endowments and foundations are more asset focused and total-return oriented, and have less complex requirements than, for example, a corporate pension plan, which need liability valuations, glide path development, and funded status monitoring. Institutions with more straightforward needs may find they are paying higher fees versus the value they're receiving, when compared to corporate pension plan sponsors. These client types should carefully review the outsourced investment fees they are charged against the services required for their specific mandate.

Closing Thoughts

The fees associated with retaining an OCIO to oversee your total investment management program are just one consideration when searching for a new provider or conducting a due diligence assessment of your current one. An OCIO relationship can offer governance and investment expertise, operational efficiency, and improved risk management. These benefits can lead to fortified standards for not-for-profit boards and retirement plan fiduciaries, and ultimately benefit your plan's participants as well as your organization's mission. To unlock these benefits, it's important to place fees in context with the quality services that will contribute to your desired outcomes.

Endnotes

1 Source: Casey Quirk, a business of Deloitte Consulting LLP.

2 Sources: Ignites, January 2021; Bloomberg Law, "Lawsuits Over 401(k) Fees Taking Aim at Smaller Employers" (September 17, 2019).

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