Arnerich Massena
Securing the Future Together

Putting Your Mission First

Why non-profits are choosing discretionary advisory services

Arnerich Massena, Inc.

June 2017

Contributors:
Ryan Cunningham, CAIA; Jillian Perkins; Terri Schwartz;
Bryan Shipley, CFA, CAIA; Chris Van Dyke, CFA, CAIA

Increasingly complex markets, resource constraints, risk management, timely decision-making, and fiduciary oversight: these are just a few of the reasons organizations are choosing discretionary or outsourced investment services. A growing number of non-profit organizations are switching to a discretionary approach to portfolio management; in this paper, we'll examine how a discretionary model can benefit an organization, and who should consider it.

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PUTTING YOUR MISSION FIRST: WHY NON-PROFITS ARE CHOOSING DISCRETIONARY ADVISORY SERVICES

How your investment advisor delivers services can bear a significant impact on both your organization and the long-term results you experience. Increasingly, non-profit organizations are moving to a discretionary approach to portfolio management. In this paper, we'll examine how a discretionary model can benefit an organization, and who should consider it.

What is a discretionary portfolio management model?
A *traditional consulting approach* focuses on making recommendations to support the committee in making investment and portfolio management decisions. In a *discretionary or outsourced chief investment officer (OCIO) model*, decisions on investment product selection, tactical tilts, and rebalancing within the boundaries of the investment policy are delegated to the investment advisor.

TRADITIONAL VERSUS DISCRETIONARY SERVICES

In a traditional advisory relationship, the investment advisor advises the committee but the power to make investment decisions rests with the committee. The advisor provides the information and research needed for the committee to make informed decisions, but in many cases, the committee is responsible for examining the research and making investment manager selections, manager changes, asset allocation decisions, and rebalancing choices. Some investment advisors provide additional fiduciary and investment education to assist the committee in fulfilling its fiduciary duties as it pertains to portfolio management. A few advisors share fiduciary responsibility for the portfolio.

Discretionary portfolio management is sometimes referred to as "outsourced chief investment officer" or "OCIO" services. Depending on how discretionary and OCIO are defined, there can be a great deal of similarity between the two structures, often referring to more or less the same thing. However, definitions vary and we have seen a spectrum of services referred to as OCIO and discretionary. On the following page, please find a detailed graphic description of what we consider to be a discretionary service model. We will refer to this as "discretionary" throughout this paper, with the understanding that it also refers to similarly defined OCIO services.

A discretionary relationship shifts the portfolio management onus onto the investment advisor. The advisor and committee identify portfolio management parameters that are set forth in an investment policy. Remaining within those parameters, then, the advisor is able to make any and all portfolio management decisions with discretion. Of course, the advisor continues to apprise the committee of any changes and report on ongoing performance. In a discretionary arrangement, the investment advisor takes on full fiduciary responsibility for managing the portfolio and selecting investment managers.

Why are non-profits considering a switch to discretionary management? Organizations are beginning to see significant advantages to a discretionary model,

Figure 1: Traditional versus discretionary services

Traditional Investment Advisory Services

Includes comprehensive investment guidance and proactive, timely recommendations.

	Traditional: Client	Traditional: Advisor	Discretionary: Client	Discretionary: Advisor
Set investment policy	✓		✓	
Set ranges for tactical allocations	✓		✓	
Asset allocation and spending studies		✓		✓
Manager due diligence		✓		✓
Select and approve managers	✓			✓
Approve tactical tilting	✓			✓
Approve rebalancing transactions	✓			✓
Performance reporting		✓		✓
Place trade orders	✓			✓

Discretionary Portfolio Management

Includes investment product selection, tactical tilts, and rebalancing within the boundaries of the client's investment policy.

depending on the their size and needs, the committee's makeup, and the long-term goals of the organization. With today's complex markets, coupled with resource and time constraints, a discretionary service model can offer solutions to the issues facing non-profit organizations and their committees. A discretionary model:

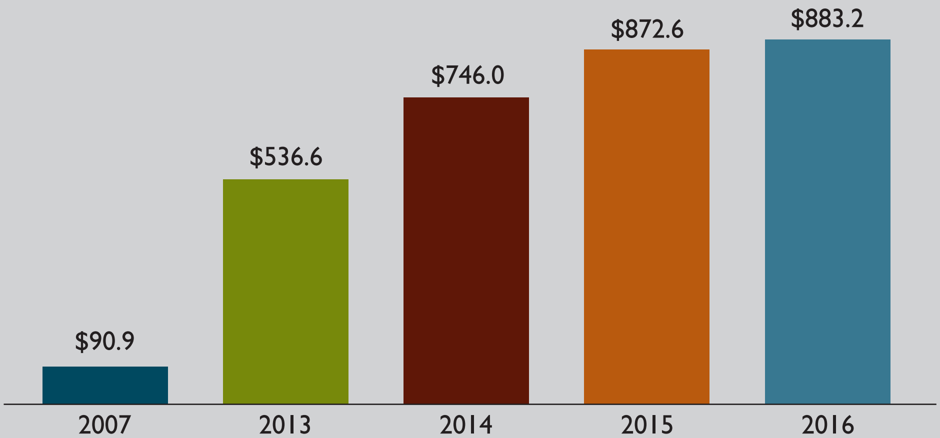
- Helps the committee focus on governance rather than managing investments
- Improves the effectiveness and efficiency of the investment process
- Aligns authority for portfolio decisions with the results

> "'The growth of the outsourcing market stems from increasingly complex and volatile capital markets, regulatory changes, resource constraints, and demand for improved governance,' Cerulli explains. 'As a result, institutions seek timelier decision-making, deeper manager due diligence, and greater oversight of portfolio risks.'"
>
> ~ *Manganaro, 2017*

Growth in the discretionary/OCIO market

The discretionary/OCIO market is growing rapidly. Estimates suggest that outsourced assets are in excess of $1.2 trillion, and that is following growth of 26% in a single year. (*Pensions & Investments*, 2014) Cerulli Associates reports that discretionary mandates have doubled in volume over the past five years. (*Manganaro, 2017*) In the 2016 Outsourced Chief Investment Officer Survey from *Chief Investment Officer*, 41% of organizations currently outsource or plan to in the next two years, which is a 54% increase from the previous year's survey. The top reasons for outsourcing cited in the survey were lack of internal resources, better risk management, and additional fiduciary oversight.

Figure 2: Growth in discretionary assets (in billions)



Source: *Chief Investment Officer*

> "Growth over the last nine years is notably impressive: Total discretionary assets rocketed from $90.9 billion in 2007 to more than $883 billion in 2016 while the number of discretionary clients soared from 479 to 11,018, respectively."
>
> *~ Chief Investment Officer, 2017*

In addition to the expanding number of organizations switching to a discretionary model, some organizations are choosing to implement partial discretion, reaping many of the benefits while still maintaining a level of control with which they feel comfortable. While 54 percent of the 2016 Outsourced Chief Investment Officer survey respondents fully outsource their complete portfolio, 25 percent of respondents reported outsourcing between 25% and 99% of their portfolios, with a small group (22%) outsourcing less than 25% of their portfolios. (*Chief Investment Officer, 2016*)

> "Nearly two-thirds (63%) of Cerulli survey respondents report their clients' desire to transfer more responsibilities to another entity… An increasing number of boards feel overwhelmed by their oversight responsibilities. Some say they don't have time to properly administer plans, they lack the knowledge to address complex investment issues, they are being pulled away from the original mission of the institution, or some combination of these concerns."
>
> *~ Moore, 2015*

A discretionary model allows the committee to focus on the organization's mission

One of the most prominent reasons for choosing a discretionary approach is that it allows the committee to focus more on the organization's mission, strategic planning, and long-term objectives. Managing an investment portfolio requires time, resources, and expertise. Most committees suffer from limited available time, and many committees are comprised of volunteers, some of whom may not have specific investment expertise. Committee members often change. A discretionary relationship relieves the committee of the burden of day-to-day portfolio management so they can focus more on oversight and governance.

Organizations cite "constraints on internal resources" as a primary reason for switching to a discretionary or OCIO model. An extremely common issue for committees, the discretionary approach offers a solution that seems to be working, given the growth of this model.

In a discretionary service model, the committee remains involved in discussing goals, identifying risk objectives, and setting asset allocation and investment parameters in the investment policy. The advisor continues to inform committee members of changes, and reporting generally occurs on a quarterly basis, just as with a traditional advisory model. However, the committee is not required to weigh in on specific investment manager selection or changes, tactical adjustments, or rebalancing. This frees the committee up to focus on what's really important, the mission and strategic objectives of its organization.

"Improved governance and risk management are other reasons institutional investors seek the services of OCIO providers, as well as increased nimbleness — an OCIO is typically able to react faster than a committee that might only meet as often as once a quarter."

~ *Comtois, 2015*

Discretionary portfolio management can be more effective and more efficient — and provide better performance potential

A survey of 600 institutional investors by Natixis reported, "Nearly half of the investors surveyed reported difficulty in staying abreast of new investment strategies at the current 'rapid pace of change and innovation.' The use of outside managers granted access to specialist capabilities and expertise, according to 49% of respondents."

~ *Chief Investment Officer, 2016*

The 2016 Outsourced Chief Investment Officer Survey reveals that additional top reasons for outsourcing investment management include better risk management and faster implementation/decisions. These issues are core reasons for the evolution and success of the discretionary model. Portfolio management requires time, attention, and vigilance. A successful portfolio will benefit from the ability to move at the speed of the markets, and many investment committees are just not able to keep up.

A committee's ability to complete their due diligence and discharge their fiduciary duty often necessitates a slow decision-making pace, which can negatively affect the portfolio and bears an opportunity cost. The process of recommending portfolio adjustments to a committee, committee deliberation, and a decision to move forward commonly takes a few to several months, making it very difficult to take advantage of market opportunities as they happen. In Mercer's investment decision-making survey, 33 percent of institutional investors said it takes more than three months for their committee to make a decision. (Mercer, 2012) Furthermore, the committee chair and members often rotate over time as new members join the committee and existing members leave. Almost half of committees report an average tenure of one to less than five years. (Vanguard, 2009) Diverging opinions and approaches, coupled with different levels of experience, can further complicate the process.

A case study

Robert Bertram, chair of the Toronto Foundation's investment committee, tells the story of switching to an OCIO model of advisory services:

"The Toronto Foundation had been using a traditional management model of an external advisor who supervised the hiring of external managers and the implementation of the asset mix. The advisor did not have a true fiduciary relationship in those decisions and left the ultimate choice of managers to the board. This usually led to a relatively protracted process to hire or replace managers or to make any changes in the asset mix, since the committee met only every three months, and it usually took at least two or three meetings to work through a decision. It was a process that made it difficult to align the interests of the managers, the advisor and the fund. The outcome was that we typically underperformed market-related benchmarks and did not consistently meet the grant objectives of the fund holders.

"The Toronto Foundation wanted to move to a model that made financial decisions in a much more efficient manner. Now all of the day-to-day investment decisions — including manager selection and asset mix changes within broad parameters — are left to the OCIO. The committee focus is now on measuring and supervising the outcome, deciding on broad asset-mix parameters and policies, and making sure there is a long-term strategic plan to meet the liability-related objectives of the foundation. The interests of all participants are better aligned to achieve the foundation's goals.

"If you don't have the scale to hire an internal CIO, then the sooner you can implement an OCIO structure, the better. OCIO provides a better alignment with — and fewer conflicts with — plan objectives than can be achieved using the advisory process."

~ *Palermo, 2015*

Committees can also be plagued with paralysis. Given difficult decisions and virtually unlimited available information, it's not unusual for committees to require extensive time to research, deliberate, and discuss choices. Behavioral economics identifies the common heuristic, "paralysis of choice," in which individuals or groups can become overwhelmed with too many choices and somewhat frozen, unable to act expeditiously.

Long-term portfolio performance can greatly benefit from the more nimble discretionary structure. Discretionary portfolio management allows the advisor to make and implement investment decisions in a more timely manner to address changing market conditions. The flexibility makes it possible for the advisor not only to take advantage of market opportunities, but also to act defensively and better manage risks.

There is a natural byproduct of inefficiency in a traditional advisory model, in which the advisor must propose a variety of solutions so that the committee can compare options as part of its fiduciary process. The process of portfolio construction and manager selection is greatly streamlined in a discretionary model, in which the advisor is able to approach the portfolio holistically based on the organization's goals. Research can be more efficiently focused on those products that best meet the organization's needs and fit into the overall portfolio.

> "In today's economic environment, [organizations] must make decisions in a more dynamic and timely way than in the past."
>
> ~ *Palermo, 2015*

The end result of greater effectiveness and improved efficiency can be seen in the long-term results of the organization's portfolio. The potential for better long-term performance is one of the objectives of moving to a discretionary approach. Quicker decision-making, defensive ability, and tactical capabilities result in enhanced long-term return potential.

A discretionary model means alignment of interests and accountability

> "The growing complexity of issues facing the investment committees of institutions and their foundations is leading more institutions to shift some of the authority for investment decisions to outside advisors to help cope with 'fiduciary fatigue.'"
>
> ~ *Bahlmann, Campanella, Heck, 2013*

With a discretionary approach, the advisor bears full fiduciary responsibility for managing the investment portfolio. The organization retains fiduciary liability for overseeing the investment program and completing due diligence on the advisor, but is relieved of the burden of fiduciary liability for day-to-day portfolio management decisions. In a traditional approach, some advisors accept fiduciary responsibility, while others do not explicitly state they are acting as a fiduciary.

The need for improved fiduciary oversight is leading many organizations to consider switching to a discretionary approach. In the 2016 Chief Investment Officer Survey, 38 percent of respondents said that "additional fiduciary oversight" was critical to their decision to outsource, and another 41 percent said it was important.

With investment outsourcing, the primary goal is the portfolio's long-term success. The structure aligns the advisor and client for a successful partnership, and reduces the potential for distractions from the long-term goal. A discretionary approach helps puts the advisor's focus fully on building a strategy that fits the organization's mission and objectives.

Evaluating discretionary/OCIO services

As with any services, not all options are alike. When seeking to move to a discretionary approach, it's critical to find the right advisor. Even more so than with traditional investment advisory services, the fit between the advisor and the organization can have a tremendous impact on the long-term success of the program.

Following are some of the considerations you can use to evaluate whether a particular partnership will best serve your organization with discretionary services:

- **Investment philosophy and process:** Just because the committee won't be involved in day-to-day investment management doesn't mean they are divorced from the process. The committee will continue to have oversight over the investment strategy and the advisor. The advisor's investment philosophy and process should align with the organization's mission and objectives. A few things to look at would be the advisor's approach to risk management and portfolio construction, what types of managers they use and recommend, and how tactical and/or opportunistic they are.

- **Governance process:** A discretionary arrangement is a partnership. Ask prospective advisors how they will work with you, including how and how often they will communicate, what reporting you'll receive, and at what points your committee will be expected to be involved in the process.

- **Independence:** Having an independent, unbiased advisor becomes even more crucial with a discretionary service model. You want to ensure that your advisor is free of conflicts of interest. Are their interests fully aligned with yours?

- **Performance:** *Chief Investment Officer,* in "The Outsourced Chief Investment Officer: A remedy for your endowment's fiduciary fatigue," lays out the issues with evaluating an advisor's performance: "You will note that investment returns are not part of the criteria we set out [to evaluate OCIO providers], as we identified three problems with ranking candidates by their past returns. First, one cannot invest in the investment returns of the past, but only in the investment *process* of the future. Second, if the potential provider customizes portfolios client by client, then those portfolios will have had different investment returns. The candidate's returns as a whole then are not relevant; only the returns of their clients that are most like our institution would be relevant. And third, since an institution aims to be a long-term investor, the most relevant returns would be over a long timeframe, possibly up to 10 years. Few candidates had a relevant investing history of that duration as outside managers for institutions like ours." *(Bahlmann, Campanella, Heck, 2013)* While we certainly recommend examining the performance records of potential candidates, we would also remind committees of the adage, "past performance is no guarantee of future returns." Committees should focus on consistency in the investment process and philosophy.

HOW ARNERICH MASSENA APPROACHES DISCRETIONARY/OCIO SERVICES

We believe a discretionary service model offers an optimal structure for a successful long-term investment program. But in our own service model, we are careful not to take a one-size-fits-all approach to discretionary services. Every organization is different with unique needs and goals. We don't ask clients to fit into our service model; we tailor our approach to each client's needs, working with individual clients to establish the degree of discretion that will best serve their organization.

At the beginning of a discretionary mandate, it's important to spend the necessary time to conduct strategic planning, design a partnership program, and outline the governance and reporting processes. Furthermore, portfolio construction should be targeted toward the right risk profile and return expectations for each client; we build asset allocation parameters based on our client's objectives. One of the most critical functions of a discretionary mandate, we learn about the organization's mission, spending needs, and future plans so that our strategy will be aligned with theirs.

Arnerich Massena has been an independent firm since our inception in 1991, and we have always accepted fiduciary status with respect to our clients. We believe in being free from conflicts of interest, in serving our clients' interest first and foremost, and in taking responsibility for our advice. As a provider of discretionary/ OCIO services, we feel that these qualities are fundamental to being a steward for our clients.

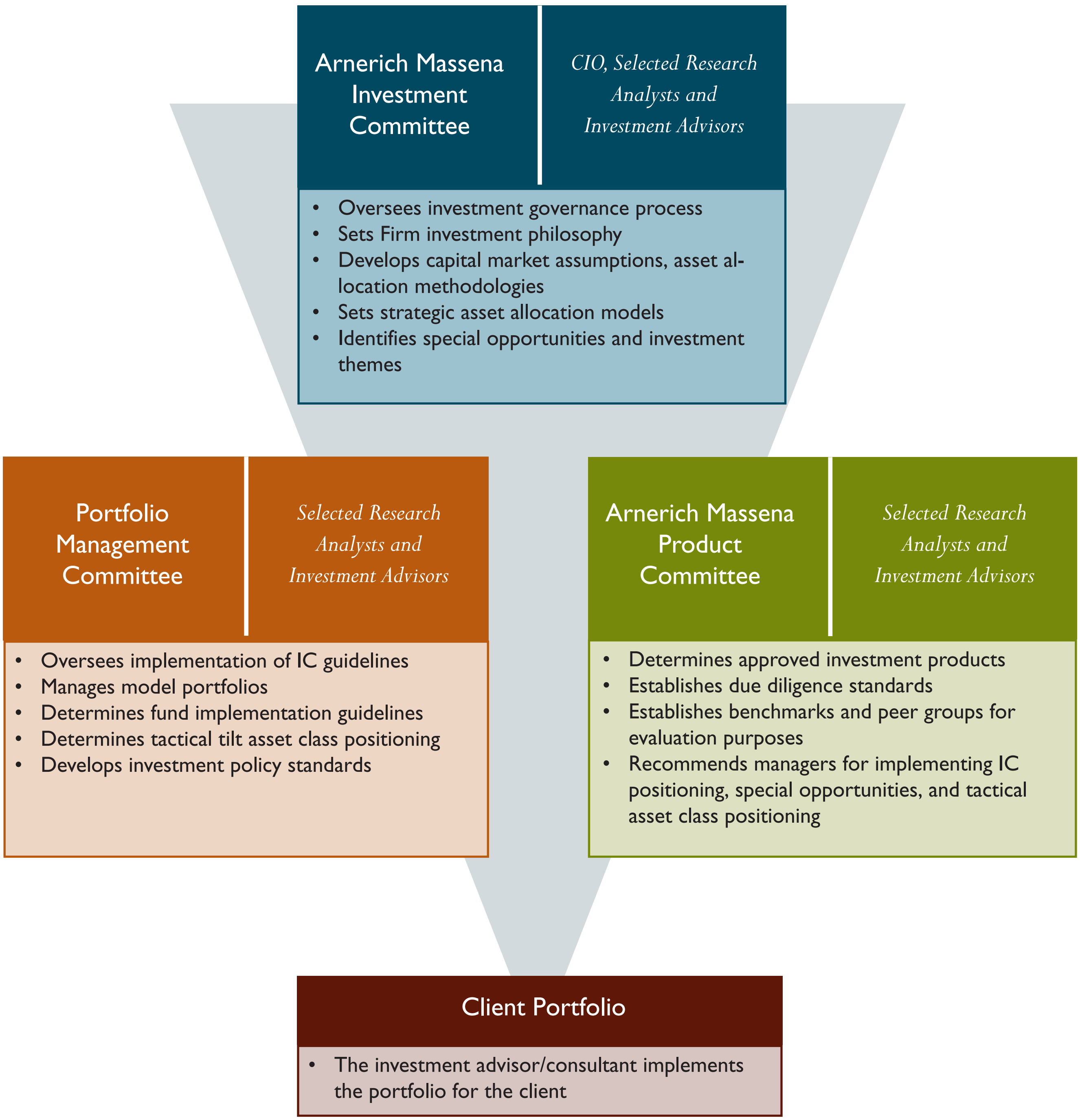
Our depth of proprietary research, expertise in sourcing and successfully investing across alternatives and capacity-constrained opportunities, custom portfolio construction, and forward-looking approach are well suited to executing discretionary portfolio management services. We use a disciplined investment governance process, which begins at the Investment Committee and includes a Portfolio Management Committee and Product Committee as well as analytical and advisory teams, addressing fiduciary functions with a thorough portfolio construction process (see Figure 3 for a graphic illustration of our investment governance process). We monitor client portfolios as markets shift, and are able to make tactical adjustments to take advantage of opportunities and to act defensively when appropriate.

We see one of the advantages of discretionary portfolio management being the ability to add greater discipline to a portfolio. Behavioral research shows that it can be very difficult for investors to eliminate emotion and invest strategically, and that applies to committees as well as individuals. Maintaining discipline in the face of market changes can be challenging; as a discretionary advisor, we provide that discipline for our clients. Our long-term, forward-looking outlook is implemented through a highly disciplined process that is designed to maximize long-term performance and minimize risk.

Finally, we think of ourselves as partner to our clients. Our job is to support our clients' organizations in the pursuit of achieving their missions. We believe in our clients, and are passionate about fostering their long-term goals and objectives. We are glad take a discretionary role in order to best support their needs.

Please feel free to contact us if you would like to learn more about or discuss Arnerich Massena's discretionary services.

Figure 3: Arnerich Massena's investment governance process



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