RVK OCIO Insights

Issue 1: A Knowledgeable Way to Evaluate an OCIO Provider : *Board/Investment Committee Structure Matters*

July 2020

Overview

Written By:

RVK's OCIO Evaluation and Monitoring Practice

RVK's Outsourced Chief Investment Officer (OCIO) Evaluation and Monitoring Team (RVK OCIO E&M Team) has been conducting OCIO education, search, evaluation, and monitoring projects for over seven years. Throughout this time, we have advised asset owners on how to navigate the particular challenges associated with evaluating OCIO providers. In RVK's first edition of OCIO Insights, we highlight three elements often overlooked by asset owners when evaluating an OCIO provider—Board/Investment Committee governance structure, key components in understanding a track record, and due diligence on business aspects of an OCIO. This document focuses on one of the three elements: Board/Investment Committee Structure. The complete RVK OCIO Insights Issue 1 can be found on RVK's OCIO website.

Board/Investment Committee Governance Structure Matters

Based on our experience working with fiduciaries, we have observed the importance of alignment between an asset owner's governance model and the OCIO provider's service model in fostering a successful engagement, and how often that alignment is assumed to exist. The concept of governance/service model "alignment" includes many aspects of an asset owner/OCIO provider relationship: meeting attendance, communication of key investment actions and their drivers, transparency in affirming compliance with investment policy and risk limitations, as well as key organizational changes, content of investment reports, and, perhaps most importantly, a clear agreement regarding which party has ultimate decision-making authority over various portfolio management decisions.

A common breakdown in the alignment between asset owners and OCIO providers is decision-making authority, particularly for governance structures transitioning from Board/Investment Committee-led decisions to OCIO-led decisions. We believe that fiduciaries take the necessary time to deliberate over this transfer of investment decision-making authority and do so with the goal of ameliorating the quality, speed, and outcomes of investment decisions. However, fiduciaries' thoughtful consideration and intentions may be missed in either the documents that govern the assets, or by the actions of new Board/Investment Committee members. That missed step can introduce ambiguity over which party has the authority to make specific investment decisions.

When the RVK OCIO E&M Team engages with a client, we begin by reviewing the existing governance structure with fiduciaries in order to confirm the current state of policies, as well as understand how the fiduciaries operate in practice. In some cases, we have discovered that policy and practice diverge, often driven by good intentions. Once the review is completed, the discussion shifts to the client's prospective preferences for goals, objectives, and management decisions for the portfolio. We have observed three aspects of governance that most commonly lead to a breakdown of alignment between the asset owner and OCIO provider:

1. Investment philosophy,
2. Veto authority, and
3. Episodic board intervention.

Investment Philosophy

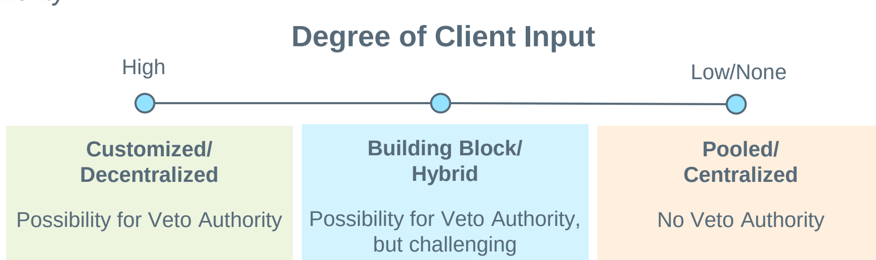
In order for members of a fiduciary body to successfully manage the institution's investment portfolio, they must maintain a consistent investment philosophy. Over time, and as members of the fiduciary body change, the consensus and investment philosophy may shift and even the manner in which the institution invests its assets can evolve away from the established and documented investment philosophy—often in directions not anticipated prior to the change in Board or Committee membership. Such a change can create challenges when evaluating and measuring the success of an incumbent OCIO provider that continues to manage assets according to objectives and expectations set by a prior group of fiduciaries.

When evaluating an incumbent OCIO or conducting a search for an OCIO provider, actual or potential changes in the fiduciary body's philosophy may also affect the type of OCIO that is appropriate to manage the institution's assets. Regardless of the type of project (evaluation or search), an OCIO's evaluation should be based upon an investment philosophy supported by a consensus reached by the fiduciaries. Investment philosophy alignment significantly increases the likelihood that the selected outsourced solution will closely align with the mission, goals, and objectives of the institution.

In order to increase the likelihood of a successful evaluation or search process, we collaborate with the fiduciary body to affirm (or reestablish as necessary) and document a cohesive investment philosophy. During this initial discovery process with the client, we review items such as the Board/Investment Committee's preference for active strategies versus passive strategies, the fund's liquidity needs and preferences, and the tolerance for "looking different" when compared to organizations the Board/Investment Committee views as peers. After confirming the institution's investment philosophy, we document it for our evaluation/search and for the Board/Investment Committee to share with the OCIO when revising the portfolio's investment policy to ensure all parties are "on the same page."

Veto Authority

Asset owner/OCIO relationships encompass a wide spectrum of decision-making delegation. On one side of the spectrum are relationships where the asset owner delegates all aspects of the investment program except for the investment policy (excluding commingled total funds). On the opposite side of the spectrum are relationships where the asset owner delegates elements of the investment policy, but maintains the ability to reject specific investments. Many relationships also exist somewhere in between these two poles. RVK refers to the ability of a Board/Investment Committee to reject an investment as *Veto Authority*.



We believe that Boards/Investment Committees should discuss their preference for maintaining veto authority and understand the implications of including it in an OCIO relationship. The existence of veto authority within an OCIO relationship can affect ownership of a client's performance track record, the speed of decision making, and operational considerations, like legal contracting. OCIO firms that implement the investment portfolio through commingled "best ideas" funds are likely not a good fit for a client who wishes to maintain veto authority. There are also several OCIO firms that implement custom portfolios via direct managers that are not willing to include veto authority in their portfolio management process.

Episodic Board Intervention

Asset owners who engage an OCIO remain fiduciaries with the ultimate authority and responsibility for investment portfolios despite the delegation. OCIO providers may be tempted, like any other vendor, to tell a client what they believe the client wishes to hear, and say they can do what they believe the client would like them to do. In our view, clear governance and clear delegation of investment decision-making authority and responsibility can mitigate such natural human instincts. However, vague governance and delegation can be fertile ground for telling/doing what the client seems to want, leading to no clear accountability for investment outcomes.

The potential implications of episodic board intervention can be seen through the following example:

A Board decides that a unique event (such as the recent COVID-19 pandemic) has temporarily changed its risk tolerance and instructs its OCIO to raise cash outside of policy ranges without making a formal amendment to the investment policy. Even though the action would violate the stated policy range, its OCIO might follow the request to preserve its relationship with the Board. Once cash is raised, the portfolio maintains an out-of-policy allocation to cash until the next regularly scheduled Board meeting three months later. During the time between meetings, risk assets outperformed and the outsized cash position in the portfolio detracted from relative performance.

This scenario prompts the question: Who is responsible for the relative underperformance? From the Board/Investment Committee's standpoint, the performance of the portfolio is the responsibility of the OCIO. In response, the OCIO would likely assert that it acted as instructed by the ultimate fiduciary. While each side has a reasonable argument, the conflict would have been avoided entirely with clear communication and documented accountability.

Clients benefit from documenting any protocols guiding Board/Investment Committee policy intervention to mitigate potentially making a harmful decision without proper deliberation. The primary issue in the aforementioned example is not the Board's intervention, but rather the lack of process to guide the OCIO or the Board on next actionable steps. To mitigate this issue, a Board/Investment Committee might consider developing policy protocols for potentially directing its OCIO to take specific actions in case of extraordinary circumstances.

About RVK's OCIO Evaluation and Monitoring Practice

RVK, Inc. ("RVK") has been providing OCIO search, evaluation, and monitoring services to institutional clients since 2012 and has conducted over 50 projects. Our OCIO Evaluation and Monitoring practice was a natural extension of RVK's sole line of business of providing non-discretionary investment consulting services to institutional clients since 1985. The success of our group has led our firm to add a companion practice—RVK Investment Program Review—focused on reviewing a Board's or Investment Committee's governance, structure, operations, and the efficacy of their own internal investment organization.

Contact us to learn more about how we can educate and guide you through the important and long-term decision of evaluating the OCIO option, hiring an OCIO, as well as to discuss how we can help fulfill your fiduciary duty to monitor and evaluate an incumbent provider.

Contact Us: OCIO Evaluation and Monitoring Team

Email: OCIOSearch@RVKInc.com

Phone: 312.445.3100

Website: https://www.rvkinc.com/services/outsourced_cio.php

Disclaimer of Warranties and Limitation of Liability

This document was prepared by RVK, Inc. (RVK) and may include information and data from some or all of the following sources: client staff; custodian banks; investment managers; specialty investment consultants; actuaries; plan administrators/record-keepers; index providers; as well as other third-party sources or as we believe necessary or appropriate. RVK has taken reasonable care to verify the accuracy of the information or data, but makes no warranties and disclaims responsibility for the accuracy or completeness of information or data provided or methodologies employed by any external source. This document does not constitute a recommendation by RVK or an offer of, or a solicitation for, any particular security and it is not intended to convey any guarantees as to the future performance of the investment products, asset classes, or capital markets.

RVK

RVK was founded in 1985 to focus exclusively on investment consulting and today employs over 100 professionals. The firm is headquartered in Portland, Oregon, with regional offices in Boise, Chicago, and New York City. RVK is one of the ten largest consulting firms in the US, as reported by *Pensions & Investments' 2019 Special Report – Consultants*. Additionally, RVK received a notable award in April 2020 when it was named a Greenwich *Quality Leader* among large US investment consultants, based upon Greenwich Associates' 2019 study. Greenwich is an industry-recognized third-party firm which asks plan sponsors to rank their consultants on a series of key metrics. Notably, RVK is the only firm among large US consultants to receive an award for a third consecutive year.[1] RVK's diversified client base of over 190 clients covers 30 states, and covers endowments, foundations, corporate and public defined benefit and contribution plans, Taft-Hartley plans, and high-net-worth individuals and families. The firm is independent, employee-owned, and derives 100% of its revenues from investment consulting services.

[1]Between July and October 2019, Greenwich Associates conducted interviews with 1,100 individuals at 896 of the largest tax-exempt funds in the US–including corporate and union funds, public funds, endowments and foundations–with either pension or investment pool assets greater than $150 million. Study participants were asked to provide quantitative and qualitative evaluations of their asset managers and investment consultants, including qualitative assessments of those firms soliciting their business and detailed information on important market trends. RVK is one of three firms recognized in the large investment consultant category. The ratings may not be representative of any one client's experience with RVK; rather they are representative of those clients submitted and that chose to participate in the survey. The results are not indicative of RVK's future performance.

To read the Greenwich article, please refer to the following URL: https://www.greenwich.com/sites/default/files/files/reports/Five-Factors-Distinguish-Best-in-Class-Consultants-Average-Practitioners.20-4012.pdf

For more information about RVK, please refer to the following URL: https://www.rvkinc.com/about/about.php

