WHEN DID THE EASY SOLUTION GET SO COMPLEX? DEFINING AND DECIPHERING INVESTMENT OUTSOURCING

Steven F. Charlton, CFA
Director of Consulting Services

Introduction

In the past decade, the investment outsourcing marketplace has exploded from just a few, relatively inflexible, funds-of-funds to a wide variety of products and providers. The investment and consulting industries have been creating products at a rapid pace in an effort to meet growing demand for more efficient and effective oversight of institutional investment pools. Industry estimates put the number of providers this year at well over 50 and growing. Prospective clients are understandably confused by the range of choices.

While the proliferation of products is exciting and offers the benefits associated with competition, the market ultimately will not be able to support such a large number of outsourcing providers. Many will simply not survive – and that raises the stakes for institutional investment programs interested in hiring an outsourcing firm.

In this paper, we will:

- Define what investment outsourcing means to investment programs
- Decode the products available, and
- Provide a roadmap for decision makers on how to identify the best solution for their needs

What is investment outsourcing?

For institutional investors, investment outsourcing means that a fiduciary delegates part of their responsibilities to a discretionary third party. As pictured below, outsourcing can involve any or all of the day-to-day oversight functions of an investment program, including asset allocation, asset rebalancing, and investment manager and custodian selection.

Why investment outsourcing?

The reasons trustees elect to outsource vary based on their specific circumstances, but some of the common reasons given for outsourcing include:

- access to specific investment capabilities and/or innovative ideas;
- inefficient processes which hinder good performance;
- better fiduciary coverage;
- lower cost structure;
- reduce financial risk with closer match of investments with goals and objectives;
- desire to focus on core competencies, such as running the organization; and

Potential Outsourced Fiduciary Functions
Asset Allocation
Asset Rebalancing
Investment Manager and Custodian Selection
Security Selection

- lack of resources or expertise to conduct research on asset allocation and/or investments.

THE MANY DESCRIPTIONS OF DISCRETIONARY PORTFOLIO MANAGEMENT INCLUDE:

- Discretionary Services
- Outsourced CIO
- Fiduciary Solutions
- Implemented Services
- Delegated Services
- Discretionary Consulting
- Outsourced Investment Management Team
- Fiduciary Management
- Implemented Consulting

Who provides outsourcing products?

Providers can be broadly categorized into the following three groups:

1. Investment Managers
2. Fund-of-Funds Investment Managers, and
3. Discretionary/Investment Consultants

The services of some outsourcing firms may overlap into more than one of those categories.

Investment managers: These are typically multi-product investment managers or custodians looking to offer a suite of proprietary investment products as a bundled solution. The proprietary investment products are often mutual funds or collective funds, each of which may be available to investors as a stand-alone service. These bundled programs are designed to be a turnkey solution for investors.

Fund-of-funds: To ease administration of complex investment programs and commingle client assets to achieve scale, an investment manager or consultant can create a fund-of-funds (or manager of managers). This one-size-fits-all investment product is designed to meet the collective needs of all investors in the fund.

In this model, client assets are typically commingled into one pool, or fund, and are managed by multiple investment managers. The manager of the fund-of-funds controls the mix of assets, as well as the investment managers, within the pool.

Under some models, a series of fund-of-funds can be mixed and matched to provide an additional level of customization for investors.

Discretionary consulting: Traditional investment consultants are evolving their businesses so that they are able to implement the recommendations they make on behalf of clients. Their products may include a fully customized investment program; a model portfolio designed to meet specific risk, return and liquidity targets; or a combination thereof. Typically, investments are made directly with investment managers, although a few firms created funds-of-funds structures.

Unlike products described earlier, fiduciaries can choose to retain or delegate nearly any function in their control to the discretionary consultant, including decisions on investment policy, asset allocation, investment manager selection, administration, and legal review. This flexibility is particularly enticing to clients new to outsourcing, allowing the client to migrate to an outsourced program over time.

How do you choose?

An institutional investor's goals, objectives, and governance structure impact the relative risks and rewards of the various products. The following table helps to outline the factors involved in the decision process:

Outsourcing Decision Criteria

Product	Goal: Maximize Risk-Adjusted Return[1]	Goal: Administrative Ease	Goal: Investment Flexibility	Goal: Minimize Potential Conflicts
Investment Manager	X	X		
Funds-of-funds	X	X	X	
Consultants	X	X	X	X

[1] Many firms offer strong investment capabilities, so we allowed that all three products can contribute to maximizing risk-adjusted returns. One must look beyond the broad brush conclusion to understand whether a single firm can meet the goals and objectives of a given investor.

The primary driver of the selection process should be the investment capability of the outsourcing firm. A candidate must be able to demonstrate a successful track record and the investment acumen to provide strong risk-adjusted returns.

Administrative ease, investment flexibility, and potential conflicts of interest are additional factors to weigh in any decision. Institutional investors need to consider whether they are willing to make relative sacrifices in potential investment return, investment flexibility, fees, administrative capabilities, and/or fiduciary protection when comparing products.

What are the product pros and cons?

The next section examines the three major product providers and their ability to deliver administrative ease and investment flexibility. We follow this with a discussion on potential conflicts of interest.

Investment Managers

Several investment management firms established turnkey platforms to help manage institutional investment programs, often bundling custodial services to provide a one-stop solution. While this offering is convenient, clients often sacrifice investment flexibility and face greater potential for conflicts.

No single firm can claim to have a best-in-class investment product in every asset class. Even large investment management firms with many product offerings may not have all of the necessary capabilities in-house to fully diversify a portfolio.

The defined contribution industry faced similar challenges years ago. As fiduciaries started to look into their bundled service arrangements, many found high fees for relatively uncompetitive investment programs. As sponsors recognized the fiduciary risks inherent in bundled packages, they pushed service providers to unbundle administration from investment management and for the flexibility to offer best-in-class investment programs to plan participants. This culminated in significantly better investment programs, fee transparency, fee reductions, and better fiduciary coverage.

The potential for conflicts is also large. Bundled investment managers have significant incentive to steer clients to their proprietary products, and have the ability to embed hidden and excessive fees in a client's investment program. As the defined contribution industry learned, accepting less-competitive investment products as part of a bundled investment program can result in large fiduciary risk.

We believe the discretionary outsourcing business is at the beginning of a similar rationalization, and institutional investors will demand similar investment flexibility and fee transparency. The current bundled products offer convenience, but that convenience comes at a price that may be too steep for many fiduciaries.

Funds-of-funds

Designed to provide scale and convenience to institutional clients, a fund-of-funds commingles clients' assets, making it easier to add or terminate investment managers, affect a new asset allocation, and rebalance clients' assets in a single transaction.

While it is important to acknowledge these benefits, nearly all of these benefits accrue to the fund-of-funds manager at the expense of flexibility for the client. In fact, all outsourcing platforms look to negotiate lower fees for their collective client bases regardless of whether a client is invested in a fund-of-funds or if the assets are invested directly with an investment manager.

There are two types of funds-of-funds. The first exists to meet the needs of specific client segments, such as endowments and foundations. The second is asset-class-specific fund-of-funds that provide investors investment flexibility by asset class or risk appetite.

Some segment-specific funds-of-funds have been around long enough, and are large enough, to establish value-add and staying power. These funds, typically, have relatively small investment teams spun out from a larger organization. Leading funds can have impressive records of navigating the recent market volatility with tactical moves and niche investments. For those endowments and foundations with goals and objectives that are consistent with the construct of a given fund-of-funds, it may be a reasonable choice to use the product assuming one can get comfortable with their relatively high fees.

Importantly, a segment-specific fund-of-funds typically does not offer much flexibility to investment pools of less than $500 million in assets, making them a difficult choice for investors with modestly or widely different goals and objectives. While a segment-specific fund-of-funds may be a good choice for a subset of the endowment and foundation universe, many of these institutions, and nearly all pension funds, will find the fund-of-funds' asset mix and risk and return objectives inconsistent with their goals and objectives. In some cases a fund-of-funds may be distinctly unsuitable.

Asset-class specific funds-of-funds are more flexible than their segment-specific brethren. These funds are generally designed to be asset gatherers, and can be mixed and matched to be more consistent with an investor's needs.

Despite a fund-of-funds' stated goal of providing scale to investors through commingling of assets, capacity constraints are an on-going problem. For asset classes with natural limitations, such as small cap equity, high yield and emerging markets, a funds-of-funds with large asset bases may have difficulty outperforming peers and benchmarks. A correlation can be drawn to the problems experienced by large mutual funds, where underperformance due to excessive assets and dilution of best ideas occurs regularly. Best-in-class investment managers typically do not want to be sub-advisors within a large fund-of-funds due to fee pressures and potential dilution of their best ideas as the fund-of-funds' assets grow.

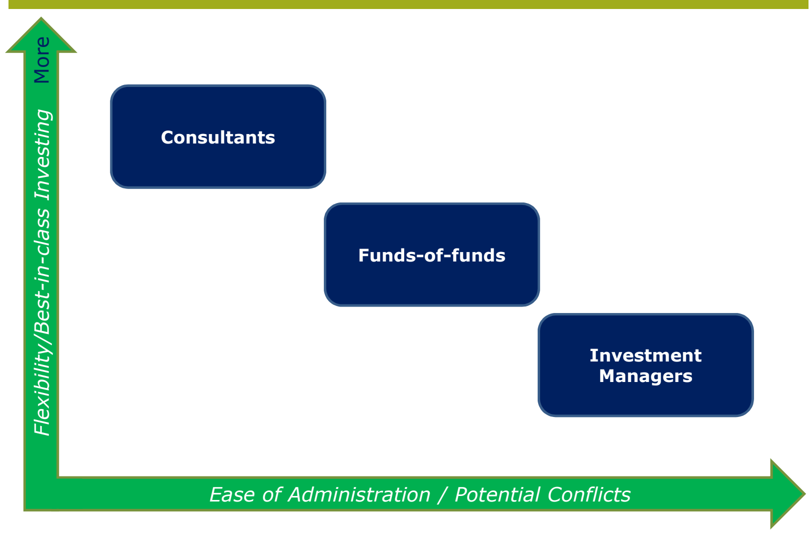
Lastly, for all fund-of-funds managers there is very little flexibility to retain the legacy assets of a new client. In fact, most fund-of-funds managers will not take fiduciary responsibility for assets held outside of their fund-of-funds. Legacy private equity, hedge funds or similarly illiquid assets will remain the responsibility of the trustees or investment committee until liquidated.

Consultants

Most consultant models offer significant flexibility in asset allocation, investment manager selection, and the ability to retain less liquid assets. Discretionary consultants typically look to use a similar investment process as used with their advisory clients. The difference is that a discretionary consultant is able to move much faster than the typical recommend-and-approve process used with advisory clients. Discretionary consultants leverage their existing research platforms to tap their knowledge of the investment management industry's products – a significant advantage for those consultants with deep, tenured research teams. Consultants also draw upon their decades of experience to tailor investment programs and strategies to a client's specific goals and requirements.

The exit strategy from an outsourcing product should also be a consideration. Most consultants invest client assets directly with best-in-class investment managers. This can be particularly attractive if termination of a consultant is necessary, as the client does not have to liquidate their investment program. Because the contract is signed between the client and the best-in-class investment manager, the client can maintain their investment program indefinitely. In contrast, most proprietary investment manager structures and all fund-of-funds structures require liquidation of the entire portfolio upon termination of the relationship because the assets are invested in the manager's products or fund-of funds. This processes could be further complicated if the manager or fund-of-funds is experiencing liquidity problems.

The following graphic illustrates the interplay between administrative ease, investment flexibility, and conflicts of interest, and the relative positioning of the various products.



Conflicts of interest

When choosing an outsourcing firm, it's important to understand where true conflicts of interest can exist, and how conflicts may impact an investment program.

One big source of conflict lies in proprietary asset management. Asset managers, whether they are active investment managers or managers of a fund-of-funds, must balance their profit motives with a client's goals and objectives.

Investment managers make more money when clients invest in their proprietary funds. Despite their fiduciary duties, a discretionary investment manager is motivated to place client assets in their funds (or fund-of-funds) whenever the client's goals and objectives are modestly similar to those of the fund. Importantly, even modest differences can result in sub-optimal outcomes, potentially resulting in outcomes far from the goal.

Another result of proprietary asset management is the issue of capacity and fair dealing. As assets grow within a fund-of-funds, it becomes more difficult to equitably spread an investment idea among clients. This issue comes to the fore when a consulting firm has an advisory business alongside their outsourcing business. If the consultant identifies a limited capacity investment idea, how can clients be assured that capacity is reserved for the fund-of-funds clients *and* advisory clients? Fund-of-funds managers can move faster than an advisory client, so the fund-of-funds will likely consume much of the limited capacity, leaving little for advisory clients.[2]

A similar argument can be made against an unbundled outsourcing business at a discretionary consultant. Ensuring compliance policies are established and vigorously enforced can eliminate this conflict.[3] Once a fund-of-funds is established, these conflicts become extremely difficult to manage, and profit motives are distinct and measureable.

Lastly, some detractors highlight the notion that discretionary clients pay higher fees than advisory clients, potentially resulting in differences in how clients are treated. We believe the higher fee is justified when discretionary clients consume greater levels of resources and create a higher level of liability (aka: risk) for the discretionary manager or consultant. In fact, it is common practice for advisory consultants to charge higher fees for larger and more complex advisory clients, just like it is common practice for investment managers to earn larger fees for more complex and specialized investment products. We believe there is no conflict when outsourcers charge higher fees for more services relative to advisory clients.

[2] Because of this conflict, NEPC decided not to create a fund-of-funds despite the potential efficiency gains we could enjoy.
[3] NEPC's internal Allocation Policy ensures fair treatment of all clients, regardless of whether they are an advisory or outsourcing client.

Conclusion

Outsourcing products are evolving rapidly. When choosing an outsourcing firm, first find the firm with the strongest investment acumen. This cannot be stated strongly enough as many products in the marketplace fall far short of the investment expertise necessary to navigate the complexities of today's markets.

The decision to outsource should not be based solely on convenience. Many outsourcing firms excel at delivering convenient, well-packaged products. Looking beyond the packaging, institutional investors may find unsatisfactory performance records. Demanding proof of performance acumen is critical, as a shortfall will far overwhelm any savings from a modestly reduced time commitment. Some established products go to great lengths to obscure their track record – and typically for good reasons. Investment results are what matter most.

Next, look for the best combination of flexibility, ease of administration, and conflict management. New outsourcing products must be supported by deep resources necessary to compete and deliver on the promise of more efficient and effective investment program management. Without a track record of success, resources should be the key determinant. Clients should be alarmed by the amount of manual processing at many outsourcing firms who lack the resources to invest in technology to safeguard client information and ensure accuracy. Also, be sure to investigate the promises of fee savings as they may not be achievable or may only be achieved with underperforming investment products.

Governance structures are also important to consider. Outsourcing is not a panacea for a poor governance structure. Even outsourced investment programs require regular oversight and evaluation of the outsourcer's product to ensure trustees fulfill their fiduciary duties.

Finally, find the product that is forward-looking, supported by the resources to evolve with your organization, and flexible enough to adapt to the ever-changing markets. Satisfying these criteria will help ensure a successful long-term partnership.

NEPC's Discretionary Consulting Services

While institutional investors ultimately must make decisions based on their specific needs and circumstances, we believe the discretionary consulting model offers the best balance of flexibility, ease of administration, and conflict management, and NEPC is the forward-looking firm with the resources to succeed.

By designating NEPC as an independent discretionary fiduciary, you authorize us to provide seamless and unbiased oversight of your investment programs. This allows you to take full advantage of our proven expertise in proactive service, asset allocation, manager selection, and outsourced administration. It also allows you to focus more on the high-priority issues within your organization.

At NEPC, we built a best-in-class approach where investment decisions are made by a senior investment committee within the consulting firm, customized to the goals and objectives of the client. Because we are able to react quickly to changing markets, we are better equipped to take advantage of opportunities not available to those with less efficient decision processes.

We look to make changes in client investment programs to effectively capture opportunities or manage threats. Ideas are implemented decisively, and money movements are tightly controlled through a technology platform designed to ensure that we safeguard our clients and transact appropriately.

While past performance is no guarantee of future success, our clients have collectively outperformed national medians in 23 of our 26 years of existence[4], and investment managers in NEPC portfolios have, on average, outperformed passive benchmarks net of fees in 15 out of the 18 traditional and alternative asset classes tracked by NEPC over the last seven years.[5]

Clients may also benefit from reduced fees and greater efficiency. By using scale to our advantage, NEPC is able to pass through fee savings from investment managers as well as asset custodians. These benefits are enjoyed by discretionary clients representing a variety of plan types, including defined benefit, defined contribution, endowments, foundations, operating assets, and health and welfare pools. Also, clients may be able to redirect their staff's efforts to other important initiatives as NEPC reduces the amount of time necessary to maintain current investment programs. Lower investment management and custodial fees, better returns, less time, and less worry are the powerful combination offered by our discretionary services model.

The NEPC Difference

NEPC's discretionary consulting service is built upon the concepts of independence and trust. We continue to remain independent and avoid the conflicts associated with managing investment products. Our independence combined with our specialized industry expertise delivered through deep research capabilities allow our clients and NEPC to build upon the success we have enjoyed for more than 26 years.

Our investment and administrative services can be customized to specific investment programs in the outsourcing marketplace, recognizing that investors may have different needs, goals, and objectives. Let us demonstrate how our depth and breadth of expertise across multiple plan types may improve results while helping you focus on your organization's key goals and objectives.

[4] National averages are represented by the median fund in the $2.5 trillion ICC Universe.
[5] This data represents the net return of all current or former managers across all current NEPC clients; managers must have at least one quarter of performance to be included; not all managers were placed by NEPC; all plan sponsor types are included; does not include passively managed accounts (index funds).

Appendix

The following outlines a list of topics and questions institutional investors might consider when evaluating outsourcing firms:

Managing conflicts of interest:

- How does the firm minimize or eliminate conflicts of interest?
- Does the firm have perverse financial incentives to get you to use their products or fund-of-funds?
- How much visibility do you have on the fees paid by you and within the fund-of-funds?
- Does scale benefit the client exclusively, or does the product retain a portion of the fees savings?
- If the firm manages a fund-of-funds as well as an advisory business, how do they maintain positive relationships with the investment managers that do not manage assets within their fund-of-funds while competing with the managers at the same time?

Track record:

- Demand a track record of client performance.
- If their performance record is not compliant with Global Investment Performance Standards (GIPS®), ask for performance of their model portfolio and a robust list of similar clients' performance.

Staying power:

- If the firm does not achieve its growth goals, how long can they stay in business?
- Are the founders tied to the business?
- Is the business material to the parent organization and its long-term growth plans?

Business continuity:

- Are there more than one or two key people?
- What would happen if a key player left the firm?
- Does the firm generate enough profit to motivate key employees, and if so, at what level of assets under management, and for how long?
- Are there outside investors and, if so, what plans are in place to repay those investors?
- If there are no outside investors, how will the firm increase revenues and resources while still paying key individuals to stay at the firm?

Reinvestment in the business:

- How does the firm attract and retain top employees?
- Who is the next generation?
- How does the firm maintain their competitive edge and continue to develop their product? Are the resources scalable and, if not, does the firm have the wherewithal to reinvest and grow their resources?

Technology:

- Protection of your investment program's indicative data is critical, so what systems are in place to process and protect your fund's data?
- How many processes are manual and prone to error?
- Has the firm made significant financial investments in their technology, will they continue to do so, and do they have the financial wherewithal?

Insurance:

- Does the firm maintain enough insurance?
- Can they survive a "mistake" over and above their insurance if there is a transaction error?

ONE MAIN STREET, CAMBRIDGE, MA 02142 | TEL: 617.374.1300 | FAX: 617.374.1313 | www.nepc.com

CAMBRIDGE | ATLANTA | CHARLOTTE | CHICAGO | DETROIT | LAS VEGAS | SAN FRANCISCO