INVESTMENT OUTSOURCING: EVOLUTION OF THE INDUSTRY, PRODUCTS AND SOLUTIONS

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Which Way to Go?

Institutional investors finding their way through the crowded investment outsourcing landscape should choose a service that provides optimal flexibility while still giving them complete control over fund assets. Enter: the multi-manager/unbundled solution.

Unlike bundled products or funds-of-funds, this solution allows the client the choice between retaining or delegating most functions to the discretionary manager, including decisions related to allocating assets, selecting investment managers, administration and document review. Importantly, the client can take their assets with them if they decide to part ways with the outsourcing firm. This flexibility and control appeal particularly to clients new to outsourcing, allowing them to migrate gradually to an outsourced program and avoid restrictive product structures such as funds-of-funds.

To this end, NEPC, LLC ("NEPC") offers a custom unbundled solution where investment decisions, consistent with your goals and objectives, are made by our senior investment committee. We look to make changes in client investment programs to effectively capture potential opportunities and manage potential threats. Ideas are implemented decisively and money movements are tightly controlled through a technology platform designed to safeguard our clients and ensure appropriate transactions.

THE MULTI-MANAGER/UNBUNDLED SOLUTION OFFERS OPTIMAL FLEXIBILITY WHILE GIVING COMPLETE CONTROL OVER FUND ASSETS

While past performance is no guarantee of future success, our advisory clients have collectively outperformed national medians in 24 of our 28 years of existence.[1] Investment managers in NEPC portfolios have, on average, outperformed passive benchmarks in 15 of the 16 traditional asset classes tracked by NEPC over the last seven years.[2] Our discretionary total return clients[3] and corporate LDI clients[4] have also outperformed their respective medians, after fees, for the three years ended December 31, 2013.

In this paper we will define and categorize the different investment outsourcing products currently available to institutional investors. We will also highlight why we believe NEPC's offering is the best option for certain investors.

[1] The national average is represented by the median fund in the $1.9 trillion InvestorForce Universe (or the ICC Universe through 2011). NEPC and universe results are both gross of manager fees. Past performance is no guarantee of future results.

[2] The data represents the average gross return of all current or former managers across all current NEPC clients. Not all managers were recommended by NEPC; it does not include 401(k) plans or index funds.

[3] The universe median is the median Endowment Fund in the $1.9 trillion InvestorForce Universe. NEPC and universe results are both net of manager fees. NEPC client performance does not include NEPC's fee. NEPC's fees for discretionary services vary by client but generally range from 5-50 basis points (0.05% to 0.50%) of assets per year. The NEPC total return composite is composed of four investment pools with similar risk and return goals and total assets of $282 million. Past performance is no guarantee of future results.

[4] The universe median is the median Corporate Fund in the $1.9 trillion InvestorForce Universe. NEPC and universe results are both net of manager fees. NEPC client performance does not include NEPC's fee. NEPC's fees for discretionary services vary by client but generally range from 5-50 basis points (0.05% to 0.50%) of assets per year. The NEPC corporate LDI composite is composed of four investment pools with similar risk and return goals and total assets of $832 million. Past performance is no guarantee of future results.

The Lay of the Land

The investment outsourcing marketplace has exploded from just a few relatively inflexible fund-of-funds ten (10) years ago to a wide variety of products and providers, as we discussed in our earlier paper "When Did the Easy Solution Get So Complex? Defining and Deciphering Investment Outsourcing," published in September 2012. At that time, there were around 50 firms providing some level of investment outsourcing. As of February of 2014, that number has grown to over 85, according to *aiCIO*'s recent article describing their "2014 Outsourced Chief Investment Officer's Buyer's Guide." Outsourced Chief Investment Officer (OCIO) firms provide a broad array of products and solutions. Most offer day-to-day oversight of an investment program, including allocating assets—either opportunistically or simply rebalancing—and the selection and administrative work that go into hiring investment managers.

While the proliferation of investment outsourcing products to meet the growing demand for more efficient and effective oversight of institutional investment pools breeds healthy competition, the market ultimately will not be able to support such a large number of outsourcing providers. Industry estimates indicate that OCIO firms will need at least $5 billion of assets under management to establish credibility and staying power. Currently, there are about 40 firms with over $5 billion in discretionary assets, according to Charles Skorina's March 31, 2014 Ultimate Outsourcer List (Version 3.1). To this end, it is easy to imagine at least a handful of the 85 firms falling by the wayside or being acquired by larger firms. In fact, the marketplace already has seen some OCIO firms fail. This raises the stakes for institutional investment programs interested in outsourcing as products and solutions may not survive.

THE MARKETPLACE ALREADY HAS SEEN SOME OCIO FIRMS FAIL, RAISING THE STAKES FOR INSTITUTIONAL INVESTMENT PROGRAMS

With NEPC, clients can be comfortable that they are in the capable hands of an established provider with over $5 billion in discretionary assets and over $800 billion in advisory assets.[5] Our organization has made a conscious decision to maintain our independence in order to serve the best interests of our clients. This includes decisions such as: remaining a firm owned and operated only by NEPC's Partnership, refusing to create multi-manager funds-of-funds due to the conflicted fee structure, and refusing to take fees or commissions from investment managers or products placed in our client portfolios. By designating NEPC as an independent discretionary fiduciary, you authorize us to provide seamless oversight of your investment programs. Our solution allows you to take full advantage of our proven specialization in proactive service, asset allocation, manager selection and outsourced administration.

Clients may also benefit from reduced fees and greater efficiency in some instances. By using scale to our advantage, NEPC is able to potentially pass through fee savings from investment managers and asset custodians, and potentially lower legal fees. Also, clients may be able to redirect their staff's efforts to other important initiatives as NEPC reduces the amount of time necessary for staff to maintain current investment programs.

Investment Outsourcing: The Spectrum of Solutions and Product Types

It is important for institutional investors to understand the types and attributes of solutions and products available. The myriad product names and types of offerings may get confusing but, essentially, there are three main categories of products and solutions available in the marketplace:

- Multi-manager/ unbundled solutions
- Fund-of-fund products
- Single fund products

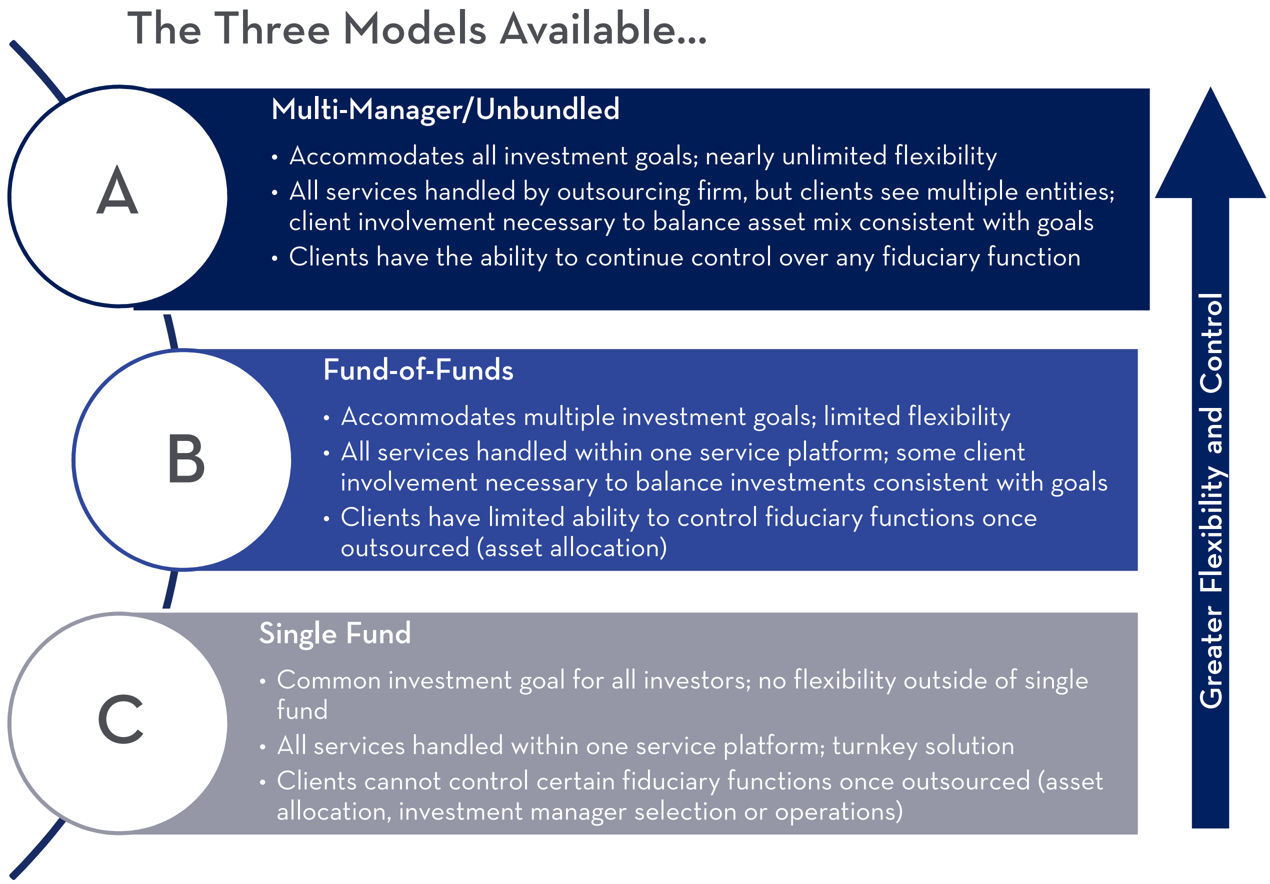
Exhibit 1 on the following page summarizes the three categories, with the advantages and disadvantages of each.

How Do You Choose?

An institutional investor's goals, objectives, and governance structure impact the relative risks and rewards of the various products and solutions. The investment capability of the outsourcing firm should be the primary driver of the selection process. A firm under consideration should be able to demonstrate a successful track record to ensure

[5] As of June 30, 2014

Exhibit 1[6]



it possesses the investment acumen to provide strong risk-adjusted returns. Demanding proof of performance is critical as a performance shortfall will overwhelm any savings stemming from lower investment fees or reduced time commitment.[7]

In our earlier paper, "When Did the Easy Solution Get So Complex? Defining and Deciphering Investment Outsourcing," we stated three factors that should influence the selection process for institutional investors beyond performance: administrative ease, investment flexibility, and potential conflicts of interest. We now believe control over assets and liquidity should also be an important consideration. Case in point: NEPC has acquired some clients from other OCIOs who ran into trouble over the last few years. Performance of the prior firms' liquid products suffered relative to benchmarks as clients fled, and these same clients are still waiting in line to reclaim some of their assets due to the illiquid captive investment structures. A loss of liquidity due to problems with the investment manager can be particularly damaging and costly, resulting in a significant haircut on the value of investments or the inability to access money for a potentially significant period of time if a single fund or a fund-of funds needs to wind down.

Four Factors Beyond Performance That Should Influence The OCIO Selection Process
1. Administrative Ease
2. Investment Flexibility
3. Potential Conflicts of Interest
4. Control of Assets

To this end, the multi-manager/unbundled solution offers the most flexibility (Exhibit 1). Unlike fund-of-funds, multi-manager/unbundled solutions allow investment committees to retain or delegate nearly any function in their control to the discretionary manager. Also, the client maintains control of the assets and can take their assets with them if they decide to part ways with the OCIO firm. While not all clients will come to the same conclusion based on their specific needs and circumstances, we believe strongly in the multi-manager/unbundled model.

[6] Source: NEPC as of June 30, 2014
[7] Past performance is no guarantee of future results

In addition, hidden conflicts, such as fee incentives geared to steer clients towards a firm's proprietary products that do not benefit your investment program, can be detrimental to your investment program. At NEPC, we believe that understanding and focusing on ways to mitigate potential conflicts of interest is critical. This belief is the very foundation of NEPC and guides the development of our solution in the OCIO space.

Our discretionary services solution offers powerful benefits, including potentially lower fees related to investment management, custodial and legal functions, while freeing up time for our clients to focus on other priorities within their organization. We believe our client performance reinforces the benefits we deliver and is testament to our skill and diligence. We invite you to learn more about our capabilities and the benefits of our unbundled approach to OCIO services. For details, please call Steve Charlton or your NEPC consultant at 617.374.1300.

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