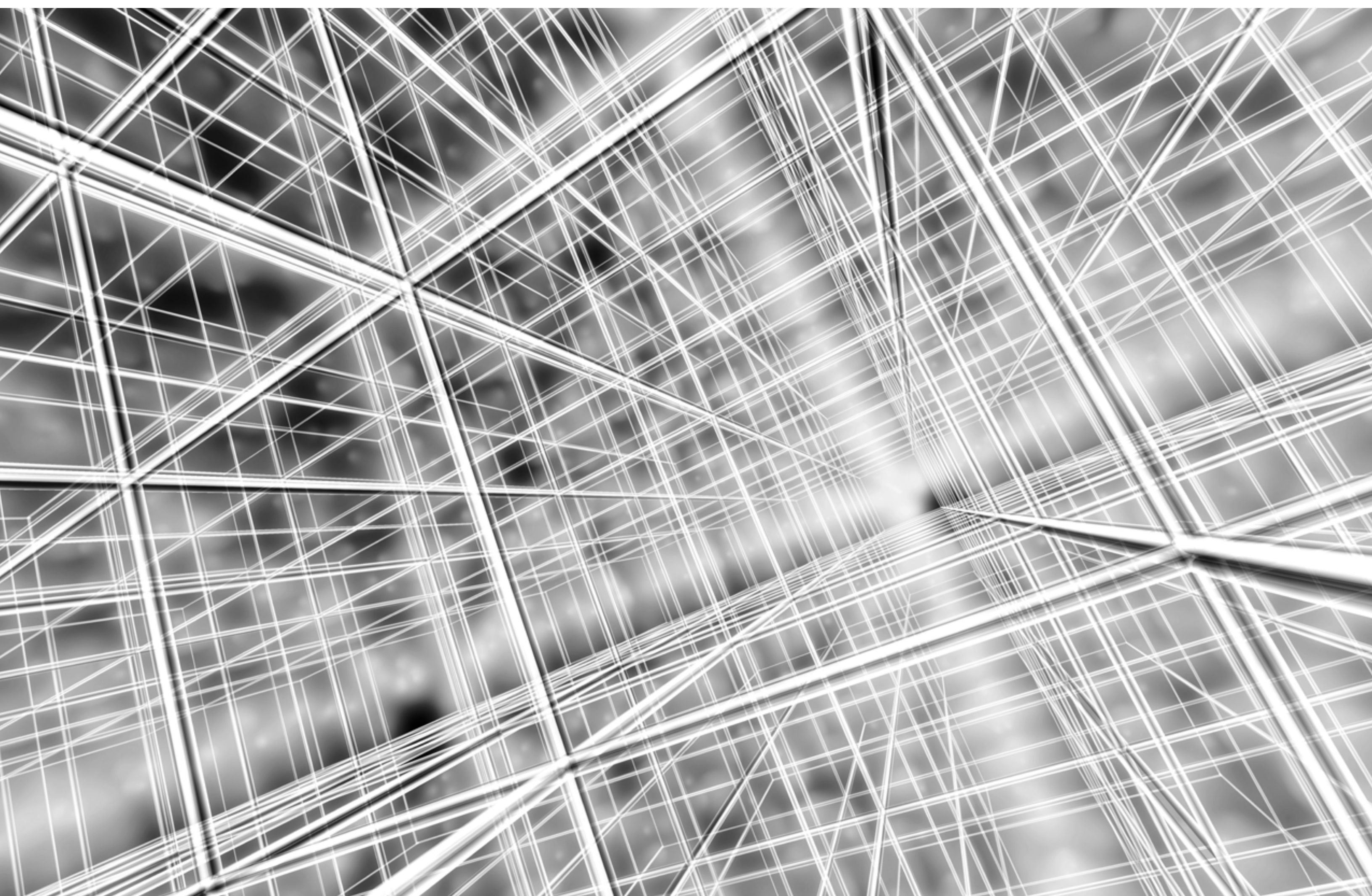
CAPCO

EVOLUTION OF OUTSOURCED CHIEF INVESTMENT OFFICER (OCIO)



INTRODUCTION

The Outsourced Chief Investment Officer (OCIO) market, which originated in the 1970s from the need to bridge the gap between investment consulting and asset management, has reached multiple inflection points throughout its history and appears to be at one again today. The OCIO market developed its foundation throughout its first 30 years, but it was not until after the technology bubble collapse of 2000-2002 and the Great Recession of 2007-2008 that the OCIO industry experienced rapid growth.

While there was an expectation the industry was moving into early-stage maturity partly evidenced by increased consolidation and slower growth rates, we see a parallel today with the recent market dislocation due to the pandemic helping reshape the evolving OCIO industry as asset owners revaluate their go-it-alone strategies and/or their current OCIO providers.

This crisis, in essence, has heightened the awareness around the difficulties of managing investment portfolios through illiquidity. The need to rebalance has made those that were not using OCIO wonder if they have the expertise to meet the objectives of their organization with its established investment management structure.

The market's potential attractiveness has propelled firms to increase capacity to meet the coming surge in demand, with large OCIO managers investing heavily in technology not only to better manage this growth, but to also address the next wave of outsourcing, mass customization. Therefore, to be successful in the OCIO market, firms need to strengthen their infrastructure, capabilities, and client reach, and achieve economies of scale with high reliance on technology to remain viable.

MARKET DISLOCATION AND STRUCTURAL CHANGE IS RESHAPING THE OCIO INDUSTRY

The $1.96T Worldwide OCIO market has grown significantly – 51% over the last five years with the U.S. market growing 60% in the same time frame to $1.31T.[1] The OCIO market has grown steadily for more than 12 years, despite the constant expectation that a negative year was lurking right around the corner.[2] The recent market dislocation and market volatility has shined a long-awaited spotlight on whether asset owners selected the right OCIO firms who could meet their performance goals in volatile or down markets.

There are a few trends occurring in the market that any firm thinking of entering and effectively competing should be aware of[3]:

OCIO Trends					
Mass Customization	**Technology**	**Consolidation**	**Introduction of the Alternative OCIO (AOCIO):**	**Primary Focus**	**Increased RFPs**
Ability to deliver portfolios for multitudes of clients, built to their unique needs, risk tolerance, and constraints through leading technology	Technology is seen as critical to enhance performance, portfolio management, and automation, and is increasingly an industry differentiator	Leading OCIO firms have turned to consolidation in recent years to strengthen infrastructure, capabilities, client reach, and achieve economies of scale while lowering fees	AOCIOs specialize in alternative investments allowing clients to receive preferential fees from underlying managers while operating in a completely open architecture	Organizations are utilizing OCIO services to handle investment initiatives while they shift focus to their core business functions	OCIOs have been seeing an increase in RFP activity due to COVID-19 from both firms who have not leveraged OCIO services before and those firms looking to change OCIO providers

Source: (1) Capco Research, Global Data 2019 (2) Pension&Investments OCIO Special Report 6/29/2020

RE-EVALUATING THE OCIO GO-TO-MARKET STRATEGY

OCIO firms need to recognize the importance of understanding the different client segments – their growth, unique attributes, needs, and pain points – to better inform their go-to-market strategy along with infrastructure, technology, and service model requirements.

Though the market has been growing steadily year over year, some segments have been growing at a faster pace. For instance, U.S. Endowments was the fastest growing segment for OCIO managers followed by U.S. Foundations (54.9% and 32.2% respectively).[4] This growth can be attributed to lagging performance for those who maintain investment management in-house contributing to the prospect of turning over investment management to an OCIO manager. In addition, with lower real rates, it is harder for foundations to hit their target rates. Therefore, they are turning to OCIOs for real return to ensure they achieve their charitable mission while supporting long term growth.

In terms of the demand composition of the overall market, defined benefit plans represents the largest segment (at 41% of large U.S. clients)[4], which reflects the relatively complex level of services required by this segment. They tend to not just require overall investment strategy and allocation determination, but leverage investment expertise in hedging risk exposures on liability-matching portfolios and benefit from the OCIO specialist's ability to construct glidepaths and provide endgame advice for maturing pensions.

Defined contribution plans, on the other hand, will look to OCIOs to set overall investment strategies and to assist with selecting managers, but the ultimate allocation decisions are made by the participant rather than the plan, therefore capping the complexity and number of services needed by OCIO firms.

Though there are differences across the segments, there are some commonalities. For instance, a recent survey[5] indicated that better risk management, faster implementation, additional fiduciary oversight, and lack of internal resources drove outsourcing decisions across all client segments.

In addition, within each segment, there are asset owners who turn full discretion over to OCIOs, but there are also asset owners who will utilize their services in a specialized manner. One of the popular areas asset owners are utilizing OCIO services for is their specialization within the ESG space. The growing popularity can be seen across the landscape, but particularly within the nonprofit space (endowments and foundations) where 69% of this group anticipates needing increased support in ESG space, according to a 2019 Cerulli survey.[5]

OCIO Client Segmentation

Defined Contribution	Defined Benefit	Foundation	Endowment
• OCIO services allow plan sponsors to focus on driving better participant engagement and outcomes rather than investments • DC's look to OCIOs to mitigate fiduciary risk, help save time in management of the plan and potentially reduce overall fees • OCIOs are involved in menu design, decision making on funds and managers	• Leverage investment expertise in hedging risk exposures on liability-matching portfolios • Given the terminating nature of many DB plans, they benefit from the OCIO specialist's ability to construct glidepaths and provide end game advice leading to pension closures • Nearly ¾ of asset owners will need advice on pension risk transfer solutions to eliminate the pension liability	• With lower real rates, it is harder for foundations to hit their target rates and are turning to OCIOs for real return to ensure they achieve their charitable mission while supporting long term growth	• Recent performance of US endowments has lagged the market and are turning to OCIO to find this return, set their investment policies, select money managers and monitor performance of the fund • Value extra services such as donor communications and development of educational materials

Source: (1) Pension&Investments OCIO Special Report 6/29/2020 (2) Chief Investment Officer 2020 Outsources-Chief Investment Officer Survey % of Large US Clients. Large is defined as having ~ $580 million in assets

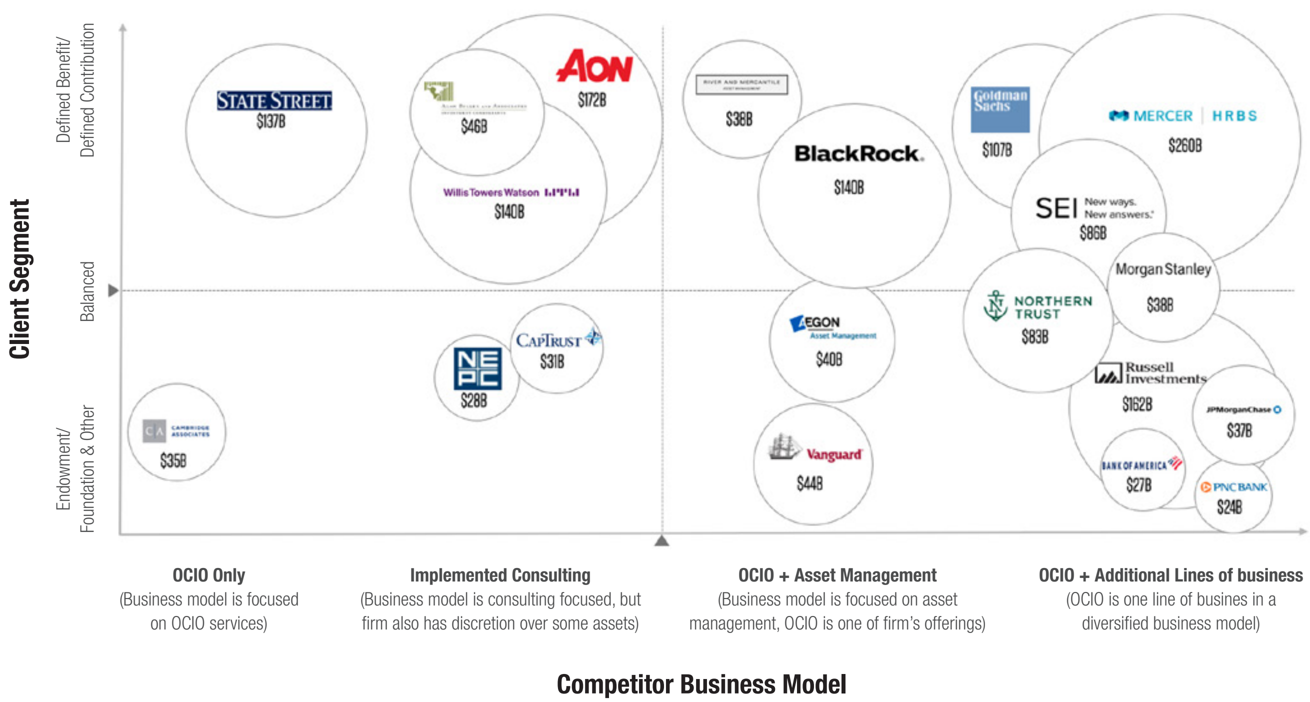
NAVIGATING THE OCIO COMPETITIVE LANDSCAPE

Understanding the key players and competitive archetypes in the marketplace, their current OCIO business model, and where they currently play (i.e., client segmentation) will help dictate a differentiation strategy and define capabilities required to execute on that strategy.

It is important to appreciate the increased competition and level of market saturation across the OCIO landscape. This is partly due to new entrants looking to capitalize on the projected growth trajectory. Different service providers are leveraging their existing relationships as seen by the increased conversion of investment consultants to OCIO managers. Building off these relationships and established trust has proven to be a valued asset for mitigating barriers to entry.[6]

Though there are new entrants into the OCIO market, we are also seeing consolidation at the top. Within the top 20 firms by AUM, the top seven firms held 67%[7] of the total assets allowing them to benefit from economies of scale. In turn, they can invest funds at lower fees than competitors, drastically improve their offerings, and employ cutting-edge technology that leaves other firms struggling to compete.

OCIO COMPETITIVE LANDSCAPE



Source: (1) Pension&Investments OCIO Special Report 6/29/2020, AUM as of 12/31/19 (2) Chief Investment Officer 2020 Outsources-Chief Investment Officer Survey

The OCIO market can be divided into four main business models[8] – firms providing only OCIO services, those who have implemented OCIO services but are consulting focused, asset management firms who offer OCIO services, and finally, the large financial institutions that offer OCIO services as one of their many services.

Typically, these firms focus and dedicate their resources, services, and offerings on one or two client segment groupings, either the defined benefit and defined contribution clients or the endowments and foundations, given the similarities in services desired by both groupings of customers. This is seen even among the largest players in the market, per AUM, where they have a focused strategy. For example, BlackRock[9] uses Aladdin's risk management capabilities to set it apart within the defined benefit and defined contribution space where assistance around de-risking portfolios and liability driven investing is key. And in the endowment and foundations segments, Vanguard[10] and Russell Investments[11] have begun to set themselves apart by investing in technology that provides real-time views across allocations, advice, and risk which are all important to this customer space.

TECHNOLOGY BECOMES CRITICAL

Asset owners lack the resources and technology necessary to meet overall investment needs, support customized, complex allocations, and provide accurate risk management and are therefore turning to OCIOs to provide solutions. As such, the OCIO business has become one of scale with high reliance on technology. To meet client's evolving needs, 91% of OCIOs have recently invested in technology, 41% built internally, while 50% invested in external technology to meet the coming surge in OCIO industry demand.[8] As the industry matures, effective technology will be a means of survival and serve as a barrier for entry among new firms. With 'mass customization' as the next wave of outsourcing, the ability to deliver portfolios for multitudes of clients, built to meet those clients' unique objectives and constraints and implemented as a cost-efficient solution, will be only possible through cutting edge technology.

CONCLUSION

The Outsourced Chief Investment Officer (OCIO) market, had seen significant growth, but over the last few years there was an expectation that growth would slow. However, recent market dislocation has challenged conventional thinking around this potential growth trajectory as asset owners revaluate their go it alone strategies and/or their current OCIO providers.

As we consider the evolution of the OCIO market over time, we see parallels between the market reaction to COVID-19 and the Tech Bubble of 2002 and the Financial Crisis of 2008, inflection points serving as a catalyst for renewed growth. This growth in the marketplace is driving increased competition, reaffirming the need for OCIO firms to adapt to this structural change by redefining their market strategies and target customer segments, while challenging fundamental assumptions about their business models to capitalize on subsequent opportunities.

To be viable, differentiate themselves, and meet the coming surge in demand, leading OCIO firms will need to strengthen infrastructure, capabilities, client reach, and achieve economies of scale with high reliance on technology.

For more information, please contact Matthew Berkowitz.

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