

# Ensuring your OCIO is aligned with your interests

By Gordon Fletcher and Alex Slivinski



**With nearly \$2 trillion in global assets managed by Outsourced Chief Investment Officer (OCIO) firms, many new players have entered the fray. This expanded opportunity set can make conducting due diligence more burdensome for asset owners considering the OCIO model. Principal-agent problems, including conflicts of interest, are not uncommon in the investment industry. With that being said, you can take specific actions to identify, manage and avoid potential conflicts in your search for an OCIO partner.**

Though regulations may allow certain practices, they can still create situations that lead to potential conflicts or appearance of conflict, which could require additional governance on the part of the investment decision makers. In this paper, we offer four simple suggestions for structuring an OCIO relationship that is aligned with your interests:

- Single transparent OCIO fee
- Exclusive use of unaffiliated investment managers
- No fees for investment services that vary based on the OCIO's investment decisions
- Full pass-through of manager fee savings negotiated by the OCIO over time

## Single transparent OCIO fee

Your goal is to pay an OCIO firm for its advice, implementation and ongoing management of assets. If you are a fiduciary of the plan, you are required to ensure the OCIO's services are suitable, relative to fees charged and results generated, and provided in the exclusive best interests of the beneficiaries.

A single transparent fee from an OCIO firm ensures you always know what the firm is earning for its services, making the evaluation of the appropriateness of its fees possible. The OCIO fee should be invoiced separately and be easily reconciled to ensure it aligns with the terms of contract. While this seems straightforward, some OCIO firms combine an OCIO fee along with fees on their underlying products, which may vary with the strategy being implemented. This practice makes it difficult for decision makers to understand and confirm whether the fees are reasonable.

By combining the OCIO fee with other services, such as investment management, a potential conflict of interest arises, as the revenue earned by the OCIO provider can be affected by the investment strategy advice it provides. This can create incentives for the OCIO provider to use its own products, even if better options exist in the market.

### WTW practice:

We only charge a single transparent fee and receive no additional revenue for the OCIO services we provide.

## Exclusive use of unaffiliated investment managers

For an OCIO firm that utilizes affiliated managers, an obvious potential conflict arises when manager performance is called into question. There will be times when the OCIO loses confidence in a manager's ability to generate compelling investment returns. In this case, you want a clean break from the manager. For an OCIO provider that uses unaffiliated investment managers, this is straightforward. For an OCIO provider that employs affiliated managers, a reassessment might require a decision about whether to fire its own team.

Another consideration is if your OCIO provider competes with money managers to trade securities; in this case, the investment management community will be reluctant to share their best ideas with the OCIO. This contrasts to an OCIO that does not directly compete. In this case, the money managers will meet with the OCIO to discuss their best ideas without any concerns of commercial sensitivity. What this means for you is that the best ideas from the investment world should make their way into your portfolio.

Using an open architecture approach, exclusively composed of unaffiliated investment managers, is one of the best ways to ensure your manager selection activities are aligned with your interests.

**WTW practice:** We use only unaffiliated managers and do not directly compete by trading securities.

## No fees for investment services that vary based on the OCIO's investment decisions

When OCIO providers earn fees for other investment-related services (Figure 1), their investment decisions can have a direct impact on their revenue and profitability. You need to be sure that the advice your OCIO brings you is in your best interests as opposed to your OCIO's interests.

**Figure 1.** Common supplemental services that some OCIOs provide (see appendix for more detail)

 <b>Proprietary-traded funds</b>	 <b>Transition management</b>
 <b>Custodial services</b>	 <b>Securities lending</b>
 <b>Soft-dollar arrangements</b>	 <b>Overlays</b>
 <b>Cash equitization</b>	

In addition, OCIO providers that offer other for-fee services can be incentivized to direct you toward those services even when they may not be appropriate. Your OCIO may not be the best provider for these services, and you may have lost the ability to bid these services out in a competitive process. The exclusive use of third parties for these investment services is one of the best ways to ensure your OCIO's advice is aligned with your interests.

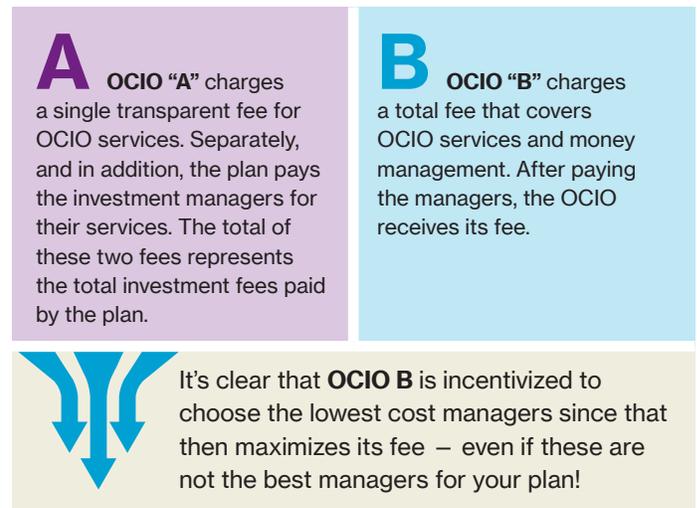
**WTW practice:** We earn no fees from other investment services.

## Full pass-through of manager fee savings negotiated by the OCIO over time

Any OCIO with scale should be able to negotiate lower fees on your behalf over time, either for investment management or for the supplemental services mentioned above.

When lower fees are negotiated, you may expect 100% of the savings to go to you 100% of the time. It is your OCIO's fiduciary obligation to act in your best interests. This includes negotiating market competitive fees on your behalf. There's no reason for an OCIO to ever keep any of the negotiated savings for themselves.

**Figure 2. Illustrative Example**



**WTW practice:** Our clients receive 100% of the savings 100% of the time.



## Conclusions

As you consider which OCIO is the best fit for you in the future, we recommend you consider evaluating these four criteria to help build a trusting and transparent long-term investment partnership.

We've included a simple checklist below that you can leverage in your reviews. We encourage you to question and challenge all OCIO candidates on each of these items. If you're considering Willis Towers Watson, know that we tick all the boxes below.

Figure 3. OCIO conflict management checklist

OCIO conflict management checklist	
<input checked="" type="checkbox"/>	Single transparent OCIO fee
<input checked="" type="checkbox"/>	Exclusive use of unaffiliated investment managers
<input checked="" type="checkbox"/>	No fees for investment services that vary based on the OCIO's investment decisions
<input checked="" type="checkbox"/>	Full pass-through of manager fee savings negotiated by the OCIO over time

## Appendix: Potential for misaligned incentives for common supplemental investment services

To clarify, we're not suggesting that each of the services below are "bad" but rather that they can provide your OCIO with misaligned incentives if bundled with OCIO services.

Common supplemental services some OCIOs provide	Potential misaligned incentives
<b>Proprietary-traded funds</b>	Steer you to their own solutions managed by their own trading desk; may not be best in class; may earn fees from trading and potential conflict in assessing investment performance of their own team
<b>Transition management</b>	Churn portfolio to generate more transitions; recommend transition management even when it doesn't add value net of fees; may provide transition management in an asset class for which they are not as qualified as another provider
<b>Custodial services</b>	Steer you to their own solutions, which may not be best in class; obscure unsatisfactory results or forward-looking prospects
<b>Securities lending</b>	Steer you toward funds with securities lending that may have a revenue share that is uncompetitive if bid to other market providers
<b>Soft-dollar arrangements</b>	Select higher-cost brokerage services in order to generate research or data benefits to OCIO at your expense
<b>Cash equitization</b>	Steer you toward solutions that may have fees and risks that are uncompetitive if bid to other market providers
<b>Overlays</b>	If fees are linked to derivative exposure, may advocate for increased leverage in liability hedging portfolio

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