

Outsourcing: Writing Your RFP

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Once an institution decides to pursue the outsourced CIO or investment office option, it usually leads to the creation of a request for proposal, or RFP. Considering that the outsourced model is a strategic partnership with some degree of shared fiduciary responsibility and a greater degree of discretion, it is critical to research and ask the right questions during the evaluation process. Based on best practices of the outsourced service model, the following are some critical areas that should be taken into consideration and researched during the RFP process.

GETTING STARTED

The one pitfall many get caught in is not being decisive in the specific governance model or type of provider they are looking for up-front, and thus they rely on the interview process as a way to educate the committee. Oftentimes, institutions will issue an RFP to traditional consultants and OCIO providers together. We don't recommend that. This challenges the committee to make a very critical decision on which governance model to adopt while at the same time trying to select the right provider. Spend the time up front to decide upon which model works best for your institution; don't have responses to an RFP determine that. In addition, before putting pen to paper in writing the RFP, identify which criteria are most important to you and rank the criteria by importance, i.e., depth and breadth of investment expertise, alternatives expertise, risk management competence and capabilities, flexibility in investment choice, custom reporting capabilities, transparency, ability to provide training and education, level of dedication, service and support, performance and fees. This should be formulated in a scorecard format to help assist in the evaluation process. Finally, cast a wide net, but not too wide. Reviewing RFP responses can take a long time so try to limit your search to no more than 6-8 institutions, preferably fewer; also consider putting a page limit on responses to make it easier to review.

SHOULD I HIRE AN OCIO CONSULTANT?

Increasingly, many institutions have opted to hire an OCIO consultant to manage the search process. Such consultants can often be helpful in identifying the most appropriate OCIO providers to include in your search, and in synthesizing data from RFP responses. If you have limited staff or Board time to manage the RFP review process, an OCIO consultant can provide additional resources and insight to enable you to make a decision more quickly.

EXPERIENCE AND COMMITMENT TO OUTSOURCING

By some counts there are as many as 100 OCIO providers, some affiliated with large banks or asset managers, some transformed from traditional consultants and some dedicated firms. Since the provider you will be choosing effectively will become an extension of your organization and assume a higher degree of fiduciary responsibility, it is critical to understand its financial resources, and its long-term commitment to being an OCIO. Consider questions as to the relative importance of the OCIO business to the broader firm, the experience of the principles, potential key person risk, and most important the relevance of that experience to your institution. Does an OCIO provider that focuses predominantly on defined benefit plans meet the needs of an endowment or foundation? Perhaps, but focus on questions that are specific and relevant to your needs.

SETTING STRATEGIC POLICY

The foundation of good governance is setting a strategic policy that provides the roadmap and guard rails for effective portfolio construction and ongoing management. In your RFP ask questions of providers as to how they would help you establish or refine a strategic policy. What are the inputs to a strategic policy? What models or tools do providers use to help inform policy? How does the provider engage with staff, the investment committee and/or board in setting strategy policy?

EXECUTION AND PORTFOLIO CONSTRUCTION

Following the setting of strategic policy, use the RFP to gain insights to how the provider seeks to execute. Specifically, how does the OCIO seek to generate returns beyond strategic asset allocation? What is their investment philosophy, and how specifically do they construct portfolios, e.g. active and/or passive; direct manager investments or commingled funds, proprietary or third-party strategies? Distinguish between manager selection and portfolio construction. What differentiates a provider's approach? Would the provider consider legacy investments, and if so, are there limitations?

EXPERIENCE IN ILLIQUID INVESTMENT STRATEGIES

For much of the last 20 years it has been challenging for endowments and foundations to maintain intergenerational equity - that is a net return sufficient to cover spending/distribution plus inflation. Those that have been more successful in achieving this goal have generally tended to have higher allocations to illiquid investment strategies, such as private equity, venture capital, private credit and private real estate - to earn a return premium above what may be available in public markets. Certainly, every nonprofit is unique and not all have the ability and willingness to allocate 15-20 percent or more to illiquid strategies. However, for those that do have such allocations or aspire to such levels, it is critical to understand the OCIO's approach to illiquid investments. Are investments made directly to managers, and if so, are all of the OCIO's investors getting equal access, particularly among those managers that may be capacity constrained? Conversely, are allocations made to a fund of funds, and if so, are all fees and expenses of that approach fully disclosed? Most important, are you gaining access, regardless of structure, to first and second quartile managers, recognizing that consistent outperformance above the median private capital manager is generally necessary in order to outperform public market indices.

RISK MANAGEMENT

Having written extensively on this topic, Commonfund believes it is important to establish a fiduciary checklist to determine the level at which risk is being managed. It's important for outsourced providers to describe the programs and procedures, including technology and software systems, they have established to monitor risk in client portfolios on an ongoing basis, as well as the ability to conduct risk management in real time. Some questions worth considering: Is there a dedicated and independent risk management team? How is risk management conducted across the firm; is it enterprise-wide? How do operations, legal and compliance initiate and conduct risk management? What level and frequency of transparency do providers offer, and which systems and applications do the investment and research teams employ to monitor and oversee security positions and counterparty risk? Are providers able to stress test and model portfolios in a real time setting or do they look through the rearview mirror? And, importantly, how has risk management impacted client portfolio decisions?

FLEXIBILITY AND ALIGNMENT OF INTERESTS

Institutions should ascertain the level of flexibility and independence providers have to determine the right fit for your institution. Some providers offer a one-size-fits-all approach, while some offer the ability to fully customize a solution to meet the specific needs of an organization. Providers often say they are independent or have completely open architecture, but when one digs deeper it becomes apparent that they work off a short list of managers or may be restricted to approved managers on their "platform." Investment outcomes are not based on the availability of more options, but it is important to understand each provider's model. Broadly it is important to use the RFP to determine the extent to which an OCIO's interest are appropriately aligned with yours. Specifically, capacity-constrained managers who are sought after pose a challenge. Either providers will avoid using these managers or will have to prioritize which of their clients get access. Furthermore, very talented and well-respected managers also may not lower their minimum account sizes or be forced to comply with specific reporting requirements just to be able to participate on an "approved list" or platform. Thus, in some cases, the field of managers is reduced by criteria that are more specific to how a provider runs its business than to what is truly best for their client's portfolio. Institutions should look for providers that can construct portfolios using an array of high-quality managers with a variety of structures to customize a program that is appropriately diversified and cost-effective.

OPERATIONAL SUPPORT

OCIO providers also vary significantly in the level of operational and administrative support they provide. Too often this is not a highly ranked priority among committees in their OCIO assessment, but it typically ranks very high among finance staff who otherwise have to do the work! Be sure to engage staff in crafting the RFP to include questions on cash flow management; audit support; the management of capital call and distributions, portfolio reconciliation, and performance reporting and attribution.

PERFORMANCE AND FEES

With many new providers entering the outsourcing space, it's crucial to evaluate their track records and determine how much discretion they exercise. Some providers may have limited experience in managing in a fully discretionary arrangement and will often show performance based off model portfolios or will assemble a hypothetical portfolio of "approved" managers. It's important to compare apples with apples. It is also important to evaluate how well a provider manages portfolios under specific risk and return guidelines; therefore, it is essential to request all performance history on discretionary accounts. Performance should be representative of actual discretionary portfolios, not just hypothetical or model portfolios, and be shown net of all fees. Regarding fees, be very specific to understand what you pay the OCIO, the underlying managers in the portfolio and the range of fund expenses, such as custody, audit and recordkeeping. Ask about potential conflicts of interest, revenue sharing agreements and how aggressively the OCIO provider negotiates manager fees on your behalf (and whether you get the full benefit of those negotiations).

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