The Widespread Impact of OCIO Growth

IN THIS ARTICLE

OCIO is the fastest-growing asset management segment today. We examine the industry trends driving OCIO growth, and discuss steps asset managers and OCIOs can take to ensure their firms benefit from this growth.

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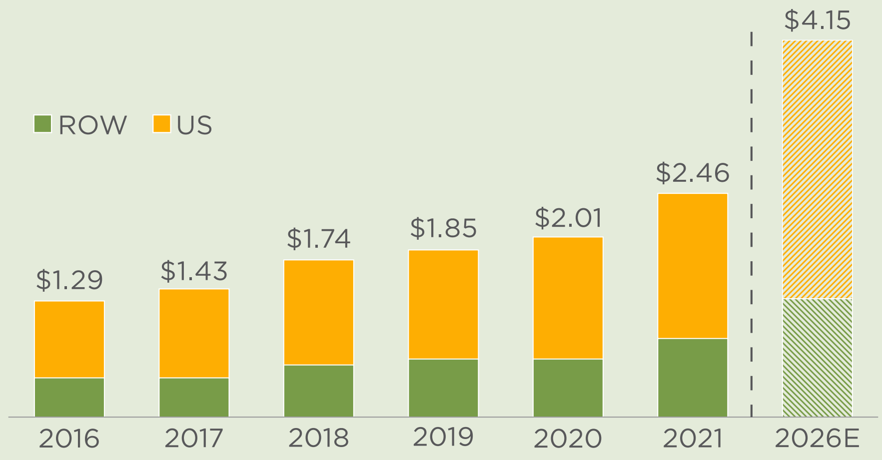
OCIO services are growing more rapidly than any other asset management market segment, and we expect that trend to continue. We forecast global OCIO AUA will exceed $4 trillion by 2026.

The two key trends driving OCIO growth are increased investment complexity and improved ease of OCIO hiring. We believe the Covid-19 crisis has accelerated both these trends.

Every asset manager and investment consultant is facing new opportunities and challenges created by the growth of OCIO. We recommend that every asset manager approach the OCIO business as a separate client channel with unique needs.

Global OCIO AUA

$ trillion USD



Source: Pensions & Investments, Chestnut Advisory Group

Chestnut Advisory Group is a boutique growth strategy consultant dedicated to asset managers and OCIOs. We provide custom growth advisory for product, distribution, M&A and brand strategies. Chestnut is a woman-owned, practitioner-led firm.

The Widespread Impact of OCIO Growth

In our strategic growth engagements with asset managers and OCIOs, the topic of how our clients can benefit from the relentless growth of OCIO services is always addressed and increasingly is a core focus. In this article we examine the industry trends driving OCIO growth, and discuss steps asset managers and OCIOs can take to ensure their firms benefit from this growth.

This article is part of our Future of Investments research project, incorporating responses from over 450 investment professionals in four key cohorts: asset managers, institutional investors, RIAs and investment consultants.

The OCIO Business: Heading to $4 Trillion over the Next Five Years

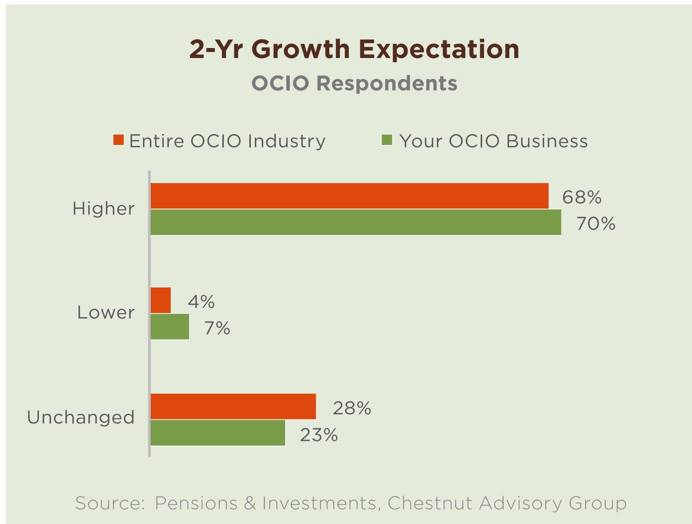
Our market research and the latest data overwhelmingly point to the same conclusion: OCIO services are growing more rapidly than any other asset management market segment, and market participants - including Chestnut - expect that trend to continue.

Global OCIO AUA surpassed $2.4 trillion in 2021, as the chart on the cover illustrates. Chestnut's forecast of $4.15 trillion in global OCIO AUA by 2026 implies an 11% CAGR over the next five years, a modest deceleration from from the last five years' 11.3% CAGR.

We use the AUA measurement as the most comprehensive view of the OCIO marketplace, as OCIO services comprise a range of full and partial discretion. Over 80% of the 2021 OCIO AUA was managed on a fully discretionary basis, up slightly from the previous year.

Market Participants Expect OCIO Growth Will Continue to Accelerate

Although global OCIO AUA grew by a whopping 22.7% over the last twelve months, OCIO providers who responded to our recent Future of Investments survey overwhelmingly forecast even higher growth over the next two years. As the chart to the right illustrates, almost 70% of OCIO research respondents forecast higher growth over the next two years than the previous two, and only 4% expect slower growth.



International OCIO is Growing Faster than US

Non-US OCIO assets totaled $834 billion in 2021, comprising just over 1/3 of total global OCIO AUA. International OCIO assets grew by over 28% in the last year and at a 15% average rate over the last five years, both exceeding the US growth rates, which we believe primarily reflects the smaller business starting point. Given the wide range of market regulation, investor segments and their needs outside the US, we forecast non-US OCIO AUA to essentially keep pace with US growth over the next five years, reaching just over $1.2 trillion by 2026.

Why: The Drivers of OCIO Growth

We believe the COVID-19 crisis accelerated two key trends supporting the strong growth of OCIO pre-crisis: increased investment complexity; and improved ease of OCIO hiring. Just like the genie which, once released, cannot be put back into its bottle, we expect both trends will continue to drive OCIO growth for the foreseeable future.

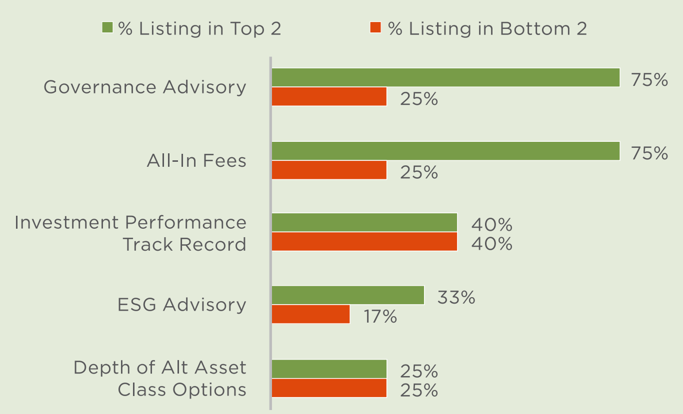
Increasing Investment Complexity Exposes the Limits of the Traditional Institutional Approach

We believe the COVID-19 crisis caused many institutional investors to realize they are not comfortable or properly structured to effectively navigate a volatile, complex, fast-moving investing environment under the traditional consulting paradigm, much less fully independently.

The traditional institutional approach of quarterly investment committee meetings to approve all portfolio allocation changes was massively challenged by volatile capital markets in the wake of COVID-19. An OCIO survey respondent explained the tie between the increasingly complex investing environment and the rapid growth of OCIO this way: “The last year was a meaningful stress test for traditional governance. If you didn’t rebalance early on, you got pummeled. If you did rebalance, you did pretty well. Rebalancing is a strong discipline for most OCIOs.”

Most Important Factors Driving OCIO Hiring Decision

Institutional Investor Respondents



Source: Chestnut Advisory Group

Our research results clearly illustrate how higher investment complexity is driving investors to seek OCIO services. Institutional investor respondents named governance advisory as the most important factor - tied only with fees - as driving their OCIO hiring decision.

A related factor driving larger and more sophisticated institutions to hire OCIOs is the increased time needed to implement and monitor the execution of investment views across a client’s portfolio due to the increasingly complex and volatile market environment. In fact, many large client OCIO relationships begin with the client outsourcing implementation tasks such as performance documentation, rebalancing and day-to-day cash management.

Governance Advisory Addresses a Wide Range of Investor Needs

Even when an OCIO has full discretion over a portfolio, the ultimate fiduciary responsibility always rests with the Board. Boards are increasingly seeking expert advice on an ongoing basis regarding how they should address a wide range of issues. The most widely-sought types of governance advisory today include:

- **Portfolio Risk/Return Goals -** Although every institution seeks to deliver strong investment performance for its beneficiaries, avoiding the perception of poor risk management is top of mind for most Board members. As new asset classes and vehicles continue to multiply, while traditional investments like fixed income become less reliable, OCIOs provide a holistic approach to helping each client articulate a set of risk/return goals that can be consistently implemented across portfolio design, management and monitoring.

- **Risk Management -** The range of risks institutional Board members are responsible for managing today have moved well beyond traditional portfolio volatility concerns and encompass everything from liquidity to reporting and documentation (ensuring the risk guidelines are being followed) to Diversity, Equity and Inclusion standards (among the Board and the investment team but also among all the institution's vendors) to Board size and tenure rules. Another important element of most OCIO engagements today is providing ongoing capital markets and investment education to the Boards.

- **ESG Implementation and Measurement -** OCIO clients seek ESG advisory across the portfolio, as a factor in manager selection, as a fair reflection of the institution's values, the desires and needs of its constituents, and more. Fully a third of institutional investors cited ESG advisory as a top two factor driving their OCIO hiring decision in our recent survey.

- **Fundraising Advice** and support has become a major focus for OCIOs serving the Endowment and Foundation marketplace.

OCIO Search Consultants Ease the Hiring Decision

Ten years ago, new OCIO engagements almost always came via an ad hoc search with participants largely selected via personal Board member relationships, or by simply transitioning the institution's existing investment consultant engagement to OCIO without running an external search. Today, we estimate somewhere between 1/3 and half of all OCIO searches are led by third party search consultants.

OCIO search consultants, most of whom are former investment consultants, use processes and analytic tools similar to those used by traditional investment consultants for manager selection, including:

- **Manager research -** Search consultants maintain proprietary databases of OCIO providers' RFP and DDQ responses covering all elements of firm operations and investment process, client relationship management, back office ODD, ESG approach, and client performance track record.

- **Creating a custom and thorough RFP** for each client OCIO search.

- **Running the RFP process**

- **Recommending a small group of finalists**

- **Negotiating OCIO fees**

Improved Transparency Pressures OCIO Fees...

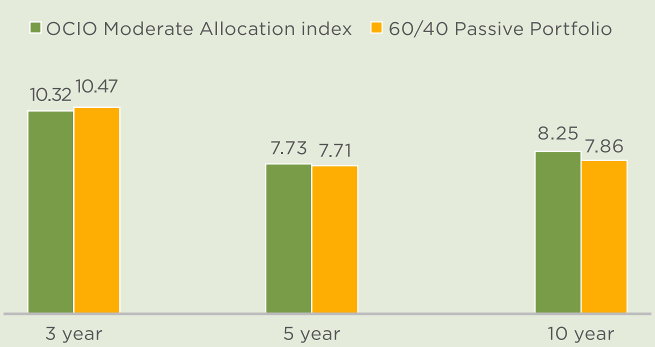
The rise of OCIO search consultants has made it possible to compare fees and performance track records among different providers. Five years ago we often heard OCIOs claiming that their clients were happy with one bundled fee. Today virtually every OCIO clearly breaks down each element of their clients' fees, from custody to manager fees (which are increasingly paid directly by the client) to the advisory fee itself. Not surprisingly, as a result OCIO fees are declining.

...and Reveals Performance Clusters Around the Mean

As governance and complexity are the primary reasons investors adopt OCIOs, we were not surprised to see that overall OCIO portfolios are not dramatically outperforming the markets. For example, the Alpha Nasdaq Moderate Asset Allocation Index (an index of investment performance) slightly underperformed a traditional 60/40 global portfolio over the last three years, delivered in-line performance over the last five years and modestly outperformed on a rolling 10 year basis.[1]

Moderate OCIO Portfolio Performance vs. Passive Portfoliopectation

Periods ended 3/31/21



Source: Chestnut Advisory Group

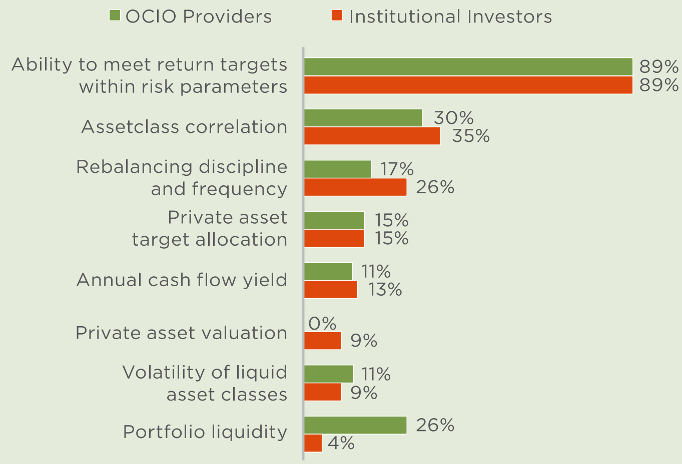
[1]Source: Alpha Nasdaq OCIO Index.

Perhaps more surprisingly, there is relatively little difference among the long-term investment performance track records of most OCIOs. For example, the trailing 10-year performance difference between the 5th percentile and the median portfolio in Alpha Capital's Endowment & Foundation OCIO universe is only 113 bps, even though three different types of portfolio risk/return approaches were included in this universe.[2] While that difference is certainly meaningful, once the wide range of needs, risk profiles and asset allocations among that group of 72 different institutions are taken into account, the range seems fairly narrow.

We view the recent launch of this new OCIO performance index, which involved widespread participation by OCIO providers, as yet another indicator that the industry is becoming a mature and significant part of the investment industry landscape.

Top Portfolio Concerns

Institutional Investor and OCIO Respondents



Source: Chestnut Advisory Group

OCIOs Have Penetrated Every Investor Segment

Although Endowments and Foundations were the first institutional market segment to widely adopt the OCIO model, today OCIOs have penetrated every investor segment, including RIAs and the private wealth channel. The over 100 OCIO providers operating today offer an increasingly wide range of investment approaches and ancillary services designed to meet the needs of different investor types. The market below the 5-10 largest providers remains highly fragmented.

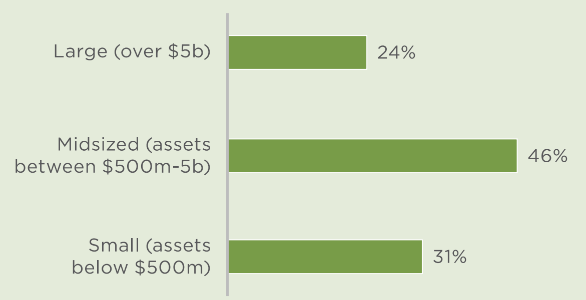
Our research into the top portfolio concerns of OCIOs and institutional investors reveals some fairly large gaps between investors' needs and OCIOs' current focus. While both groups agree that the ability to meet return targets within risk parameters is paramount, investors are much more concerned about rebalancing discipline than OCIO providers are (as we discussed earlier, we believe this rebalancing discipline is a major benefit many investors seek from OCIO providers). In contrast, OCIO providers rate portfolio liquidity as their third largest concern, while investors ranked it dead last.

Different investor segments seek different services from their OCIO providers. We discuss each major OCIO client segment below.

Endowments & Foundations: More Growth to Come

As the first movers into OCIO, Endowments & Foundations are the most highly penetrated market segment today. One recent survey found that over 1/3 of US foundations were using an OCIO in 2020.[3] Midsized non-profits have the highest OCIO use. We believe the growth opportunity for OCIO providers is largest among smaller non-profit organizations today.

% of Nonprofit Organizations Using OCIOs



Source: CIOMagazine

[2] Source: Alpha Nasdaq OCIO index. Data for 10 years ending 6/30/21, measuring 77 E&F OCIO portfolios of all sizes with asset allocations including Aggressive, Moderately Aggressive and Moderate.

[3] Source: Commonfund, 2020 survey of 260 US-based foundations.

Most nonprofit Board members are selected primarily due to their commitment to the organization's mission rather than their investment background. As a result most endowments and foundations ask OCIOs to provide investor education for their investment committee, and need help with everything from manager selection to asset allocation and Board material preparation. This need for investment services explains why private foundations in a recent survey said they have now outsourced 88% of their investment management functions.[4]

Nonprofits, with their long-term horizons and low liabilities, have been the early movers into private asset classes. Today smaller nonprofits are seeking to increase their allocation to privates. OCIO providers who can meet this growing demand for private assets among smaller investors have an advantage.

Foundations are perpetually in fundraising mode, and increasingly OCIO providers are offering advice and support in that important effort.

Corporate and Government Pension Use of OCIOs Is Just Beginning

Corporate and government institutions have very different needs than nonprofits, as they are primarily liability-driven. While these institutions' needs seem more suited for a traditional investment consultant relationship, the move to OCIO is accelerating here as well, with the most notable recent example being British Airways' hiring BlackRock in 2021 as an OCIO provider servicing $31 billion in retirement portfolios. In their press release announcing this engagement, British Airways cited 'increased investment complexity' as a key driver of this decision.

When hiring an OCIO, government and corporate institutions tend to favor traditional consulting firms and asset managers who have expanded into OCIO. One reason is of course the liability-driven nature of their needs, which makes the actuarial capabilities of investment consultants and the deep fixed income investment expertise of some asset managers quite attractive, and differentiates them as OCIO providers. In the UK, this trend raised anti-trust concerns that led to rules ensuring trustees look beyond their actuaries and investment consultants for OCIO services.

Another reason is government and corporate decisionmakers' longstanding relationships with these two types of providers. The government segment is the most highly penetrated investment consultant segment in the US, so that has been an easy conversion. On the corporate side, in addition to longstanding consultant relationships, several asset manager-based OCIOs are connected to investment banks with deep corporate relationships stemming from M&A and capital-raising work.

The Defined Contribution Market Is Growing Rapidly

Over the last year, US DC plan AUM managed by OCIOs grew by 54.8%, up to $246.4 billion.[5] At this point, approximately 15% of US DC sponsors are using an OCIO; this number rises to 24% for midsized plans.[6]

While this topline growth is attractive, not all OCIOs are rushing to win DC mandates. The primary reason is that in DC OCIO engagements, unlike all other type of OCIO engagements, the OCIO manager assumes investment fiduciary responsibility from the plan sponsor. Given the long history of expensive litigation in the DC marketplace, only a subset of OCIO providers are pursuing the DC marketplace at this point.

As the Department of Labor provides further regulatory guidance for PEPs (Pooled Employee Plans) created by the 2019 SECURE Act, these DC OCIO providers will certainly pursue that market segment.

OCIOs Are Penetrating the Wealth Channel Too

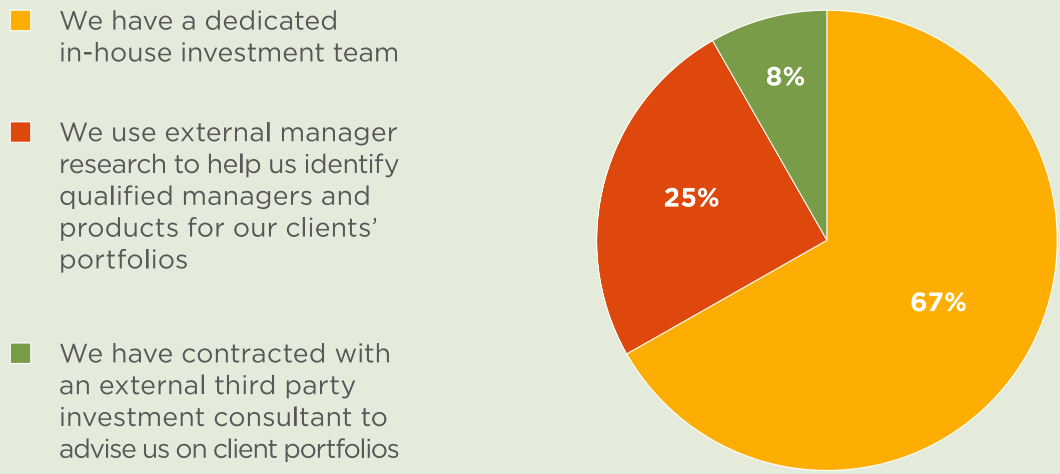
Although at first OCIO may appear to be a wholly institutional offering, the ability to build and manage a range of customized investment portfolios at scale is the classic definition of a wealth manager. Most of the largest OCIO providers now have divisions dedicated to selling OCIO services to RIAs and family offices. In turn, some large RIAs and family offices have begun acquiring OCIO providers.

[4] Source: IBID

[5] Source: *Pensions & Investments* 2021 OCIO survey
[6] Source: *PlanAdvisor*

How Does Your Firm Select Asset Managers and Build Client Portfolios?

RIA Respondents



Source: Chestnut Advisory Group

We view the acceptance of OCIO services by the wealth channel as the next step in a trend we call the Institutionalization of Retail. At the large wirehouses today there is an increasing reliance on centralized portfolio construction. The trend is the same among independent advisors: fully 1/3 of RIA respondents to Chestnut's survey say they currently use external advice to build their clients' portfolios.

It is a short hop from centralized portfolio construction to providing full OCIO services to private wealth clients, with substantial overlap in the competencies and technologies required to deliver these services. Asset managers with OCIO services are beginning to combine these two businesses, such as BlackRock, who recently created a solutions unit that includes both traditional OCIO management for institutional investors and model-based portfolios that wealth managers implement on behalf of their clients. Wirehouses such as Morgan Stanley are also increasingly competing for and winning OCIO mandates in the private wealth marketplace.

Conclusion: How to Benefit from the Widespread Impact of OCIO Growth

The growth of OCIO has created new opportunities and challenges that every asset manager and investment consultant must address in order to remain competitive. We recommend investment firms carefully consider how each of the following issues is impacting their business today, and what steps they can take to improve the outcome for their firm.

Know Your Frenemy

We use the term 'frenemy' to describe how the widespread growth of OCIO has scrambled previously clear industry relationships. As more asset managers formally launch their own OCIO businesses, these managers now find themselves competing with the same investment consultants who had previously been treated solely as important gatekeepers and clients.

The 'frenemy' challenges are many, but to give just one example, the consultant relations team at an asset manager with an OCIO offering must be able to tell a clean story to other investment consultants about that manager's OCIO business (including how the target market does or does not overlap with that investment consultant's business).

For OCIOs: Put Yourself in the Golden Circle!

OCIOs, just like all other asset managers, cannot rely on their performance alone to drive their asset flows. As we previously discussed, the improved data transparency driven by search consultants is revealing that OCIO performance is clustering around the mean. And each investor segment has a different set of ancillary services they seek from OCIO providers.

Now that each OCIO provider is competing against over 100 other providers, and they are increasingly seeking to attract and retain clients they do not previously have a relationship with, OCIOs must answer the same three critical questions all successful asset managers have successfully addressed:

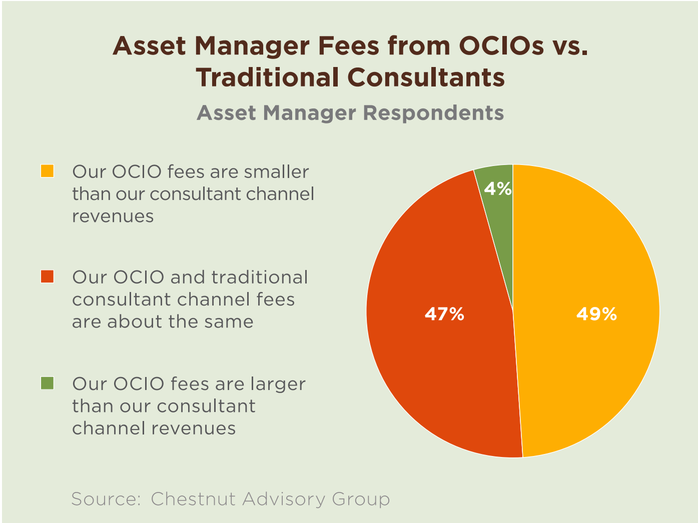
- **What do your target investors want?**
- **How can your firm deliver?**
- **Why you?**

> We recommend that every asset manager approach the OCIO business as a separate client channel with unique needs.

OCIOs with a strong 'why you' that is embedded across each element of their growth strategies - Product, Distribution, Brand and M&A - are in what we call the Golden Circle of Asset Management. OCIOs in the Golden Circle are able to develop the trust that is necessary to raise and retain capital from their target investors.

For Managers: Approach OCIO as a New and Important Distribution Channel

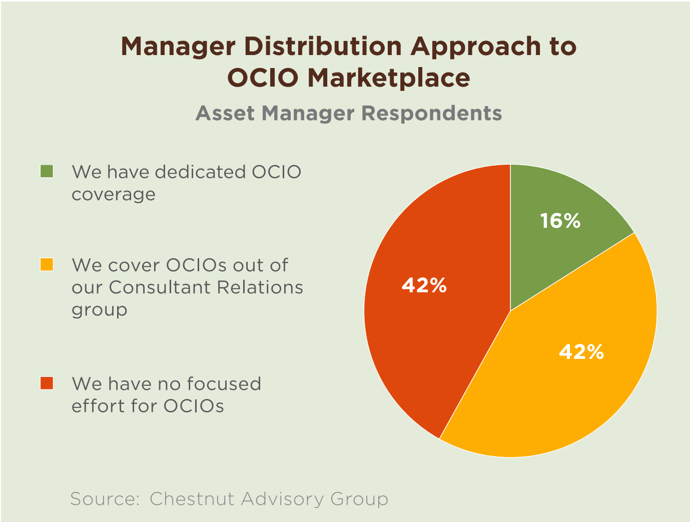
Over half the asset managers in our recent survey reported their OCIO revenues are the same or larger than their revenues via the traditional consulting channel. In our work with asset managers we have seen time and again that their business from OCIOs has grown despite their lack of focus on the channel.



Much of these OCIO-related revenues came from the first wave of OCIO growth, in which traditional investment consultants converted existing client relationships into OCIO engagements. By and large the clients' portfolios remained the same, with large allocations to the consultants' most highly-rated managers and products. Over the last decade, asset managers could continue with their traditional consultant relations approach and watch their OCIO assets grow.

Since their OCIO assets are growing, most managers don't realize how much OCIO business they are losing to competitors who are laser focused on meeting OCIOs' needs. Only 16% of asset manager respondents in our recent survey have dedicated OCIO coverage, separate from their consultant relations group. As an increasing number of asset managers launch OCIO businesses, managers who are not selling to them will be at a disadvantage.

We recommend that every asset manager, even small boutiques, approach the OCIO business as a separate client channel with unique needs, summarized below.



Unique OCIO Needs for Asset Managers to Address

- **Trust and understanding are the foundation of a successful asset manager/OCIO relationship**
  While all OCIO providers have a manager research function, the portfolio allocation decisions and ongoing client relationships are almost always led by a different group of people. These OCIO decision-makers want to engage with managers who understand and can help them address the client investing needs they are aiming to meet. A dialogue with an OCIO decision-maker should be at the portfolio level, addressing how the manager's product(s) and investment philosophy(ies) fit with the OCIO's current investment thesis and portfolio construction approach.

- **A strong product rating is just the starting point**
  A successful manager/OCIO relationship is built on a strong mutual understanding of why the manager's product(s) are a good fit for the OCIO's current investment thesis and portfolio construction approach. While an OCIO's manager selection decision set usually starts with their most highly-rated products, that is only one step in their manager selection process.

- **Carefully address each OCIO's thought leadership needs**
  Since OCIOs serve as the sole conduit of all capital markets and portfolio analysis for each client, and as consultant OCIOs do not actively invest in the market themselves, most OCIO providers rely on their managers to provide real-time capital markets insight for use with their clients. The wider the OCIO's range of client types, the broader their thought leadership needs will be. A good OCIO client manager will thoughtfully curate their firm's investment content for their OCIO clients.

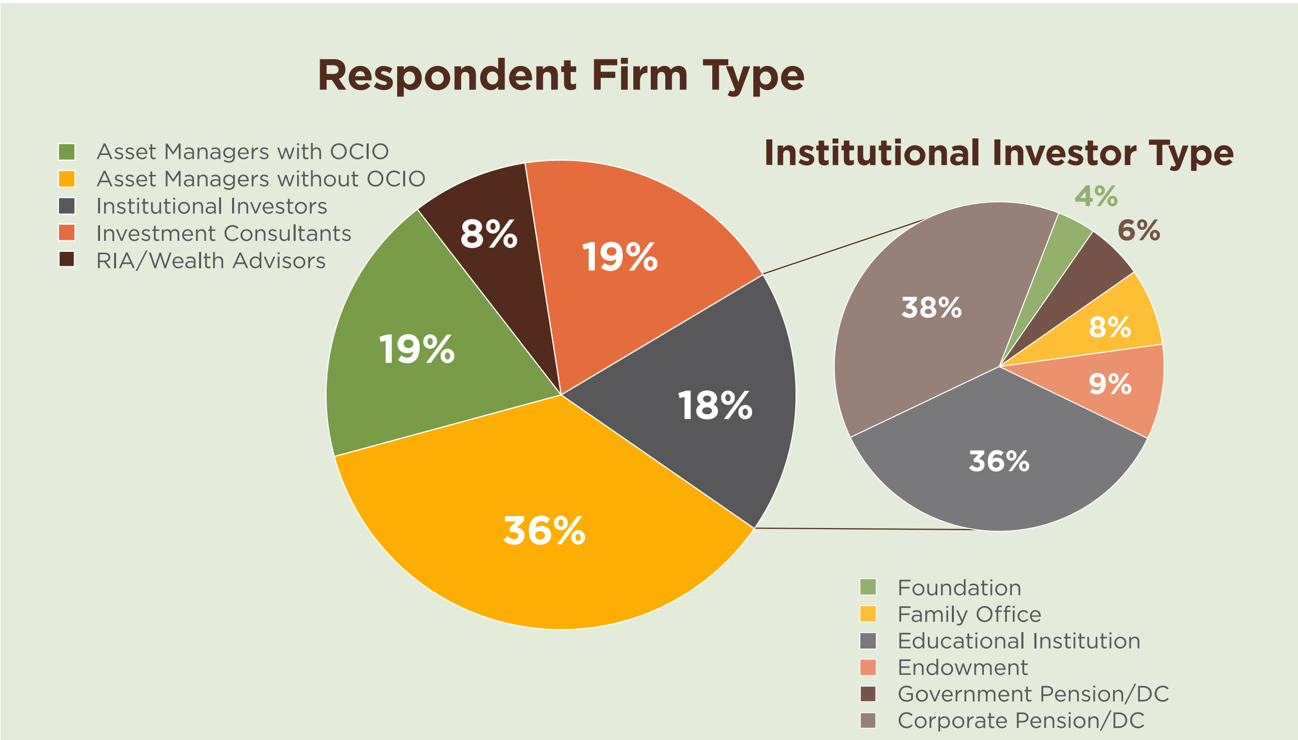
- **Be prepared to sell and negotiate at a firm-wide level**
  Like other investors, OCIOs like to partner with managers who can meet a broad range of their needs when possible. Managers with a wide range of highly rated products generally do well in this marketplace, particularly with the largest OCIO providers, as both business models are designed for scale. The negotiation will often address fees across all the products being considered for the OCIO's portfolios.

- **The ability to customize products is crucial**
  OCIOs often seek product tweaks for their portfolios, most commonly around vehicle types so the product can be offered across a wide range of client portfolio sizes. In addition many OCIOs seek other changes, to increase yield, change the risk profile or even offer the product in a new currency. Managers who can thoughtfully address these requests will build stronger OCIO relationships over time.

- **Be ready to decline OCIO business**
  We were not surprised to see that 34% of asset manager respondents told us they had turned down opportunities to be on an OCIO platform. With over 100 OCIO providers today, managers are learning to be careful not to use up precious product capacity at the low fees OCIOs usually demand. There may be other potential conflicts to address as well, so these relationships are best managed by a senior decision maker at the asset manager.

Research Methodology

As the investment industry faces unprecedented challenges, Chestnut Advisory Group and *Pensions & Investments* partnered to conduct comprehensive research into the issues impacting the future of the investment industry, your organization, and your career. Over 450 professionals from across the industry participated in our study.



Source: Chestnut Advisory Group

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Over the past nine years Amanda has helped Chestnut's clients navigate the rapidly changing industry landscape by creating and implementing custom strategic growth roadmaps. Her areas of expertise include distribution, brand and M&A strategy. Amanda brings over 25 years of industry experience to Chestnut's clients. Prior to founding Chestnut, Amanda served as Global Director of AllianceBernstein's senior portfolio management team. Previously, Amanda developed deep experience in sell-side equity research as Associate Director of Equity Research at Bank of America and as an Institutional-Investor All-America Team- ranked equity analyst at JPMorgan.

The author would like to thank Jess Hacker for her contribution to this report.