ERISA Advisory Council
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Hearing on Outsourcing Employee Benefit Plan Services

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Thank you for inviting me to testify this morning on the topic of Outsourcing Employee Benefit Plan Services. My name is Kristen Steffens; I am a Consultant and Manager of OCIO Evaluation & Analysis at RVK, Inc., an investment consulting firm.

There are many different functions that pension plans can outsource such as recordkeeping, actuarial work, and investment implementation. The focus of my comments today will be on the increased emergence of outsourcing investment implementation. There are many terms for this in the marketplace, but it is most typically referred to as discretionary consulting or outsourced-CIO (OCIO for short). Throughout the rest of my comments, I will refer to this service as OCIO.

Over the next 20 minutes, I will seek to:

- Define OCIO and discuss the various types of OCIO providers;
- Discuss RVK's role in OCIO Search and Monitoring;
- Highlight trends we're seeing in the OCIO marketplace; and
- Provide what we believe to be best practices for Plan Sponsors and recommendations for the Department of Labor (DOL).

Definition of Outsourced-CIO (OCIO) and Various Types of OCIO Providers

In general terms, "OCIO" refers to a package of services whereby a single firm assumes contractual responsibility for asset allocation, policy development, investment manager selection, portfolio funding, rebalancing, and ongoing portfolio monitoring. The scope of services included in an OCIO client relationship varies widely based on the level of investment and specific relationship desired by the client. Some clients outsource only a portion of their portfolio (for example, only the hedge fund or private equity portfolio), or outsource only certain functions (such as tactical asset allocation). Other organizations hire an OCIO and outsource implementation across their entire portfolio. Similarly, the range of providers in the marketplace also varies widely, from small boutique firms with a handful of clients to units within large global financial services firms.

In general, OCIO providers can be categorized into the following types of organizations:

- Financial services conglomerates: Firms offer a wide range of services such as commercial banking, investment banking, and brokerage.
- Actuarial firms: Typically focusing on the defined benefit market, providing both actuarial services as well as investment implementation along a pre-determined glide path.

- “Boutique” OCIO teams: Formerly the investment office and/or served the CIO function for various university endowments or corporate pension plans that now focus solely on providing OCIO services.
- Mutual fund firms: Organizations that offer mutual funds that have expanded their services to include an OCIO package, often times utilizing proprietary products in their service solution.
- Investment consultants: Some consulting firms now offer OCIO services in addition to traditional advisory consulting services.

After the financial crisis of 2008-2009, the number of OCIO providers increased rapidly. However, there have been outsourced providers in the market for many years. As the financial services industry has evolved, the lines of distinction between various service providers have also blurred. Banks, insurance companies, investment managers, investment consultants, and investment boutiques often offer similar or identical services, making the market confusing and very difficult to analyze objectively.

Just as the heritages of these firms vary, their strengths, weaknesses, and offerings vary greatly as well. It is difficult to gauge how large the OCIO market will be, and we anticipate that levels of adoption will vary greatly by investor type.

When discussing the topic of OCIO providers, it is critically important for an Investment Committee or Board to keep one very important thought in mind: the OCIO evaluation process involves two decisions, not one.

The two decisions are as follows:

1. Should our institution hire an OCIO provider?
2. If we hire an OCIO provider, who should we hire?

Arriving at the right answer to the first question involves analyzing a wide range of factors, most of which will be unique to each institution. Many different types of organizations, including endowments, foundations, and defined benefit plans, are considering the potential of moving from a Staff-driven or Committee-driven governance structure to an OCIO. The decision to hire an OCIO is highly dependent on Staff resources, portfolio structure, and Committee preferences for the level of involvement they would like to maintain in portfolio management and implementation.

Hiring an OCIO provider is analogous to hiring a dedicated team to focus fully on meeting the investment and operational needs of the portfolio. The use of an OCIO provider may introduce economies of scale in that fewer Staff professionals (or a reduction in dedicated time from Staff professionals) may need to focus on the portfolio on a regular basis. Operational improvements may be introduced since, under a fully outsourced relationship, the OCIO has authority to execute documents and effect trades within the portfolio without the written consent of the client for each transaction. OCIO providers will also provide operational support for capital calls/distributions and annual audits. An OCIO may also improve decision making in that it helps to mitigate inherent challenges of an Investment Committee that may meet infrequently and thus may not be nimble enough to react to market movements.

For Committees or Plan fiduciaries that desire a more active role in the management of the portfolio, a traditional advisory consultant may be a better fit. An advisory consultant can bring investment recommendations and prepare paperwork, effectively doing much of the heavy lifting to support investment and operational decisions, but these decisions do still require Committee approval. Thus, under a non-OCIO arrangement, the Committee needs to maintain some level of commitment to meet, discuss, and execute on decisions for the portfolio.

There are potential drawbacks in the OCIO model, which can be significant and are worth highlighting. No single firm is best-in-class at every function within an investment program. In addition, OCIO providers may provide an extra level of expenses, which must be evaluated relative to other alternatives in running an investment program. Lastly, and perhaps most important, the Investment Committee is effectively delegating many varied and critical functions to this provider. However, hiring an OCIO provider does not remove fiduciary duty from the Committee. Under any model, the Plan Sponsor retains fiduciary duty to set the strategy (including objectives and constraints) for the portfolio, as well as provide ongoing monitoring over the service providers.

After a full review of these issues, an Investment Committee or Board may conclude that an OCIO solution either is their preferred choice, or a choice they want to consider. At that point, the focus switches to establishing the appropriate parameters to evaluate and ultimately select an OCIO provider. While the decision to hire an OCIO must be carefully considered, which OCIO provider is best aligned with the needs of the organization is equally as challenging. Plan Sponsors often look to a third party organization, such as RVK, to help lead them in the evaluation of potential OCIO firms.

RVK's Role in OCIO Search and Monitoring

RVK (formerly R.V. Kuhns & Associates, Inc.) is a national firm with headquarters in Portland, Oregon and regional offices in New York City and Chicago. The firm was founded in 1985 with the sole purpose of focusing exclusively on investment consulting. Our clients include corporations, public retirement systems, Taft-Hartley funds, non-profit organizations, non-pension operating funds, and high-net-worth individuals and families.

RVK is relatively unique among large U.S. investment consultants in two respects:

1. Our firm is 100% owned by active employees with no outside ownership interest or other potential conflicts of interests.
2. We have chosen to focus solely on consulting and not manage assets, either through an OCIO model or by offering our own investment vehicles.

As a full-service firm with no conflicts of interest or competing products, we have had a number of organizations hire us to assist in evaluating the OCIO model and/or selecting an OCIO provider.

OCIO selection and monitoring is very different, and considerably more complex, than a traditional investment manager search and monitoring assignment. Because an OCIO provider has multiple tasks, each of the functional areas needs to be evaluated independently. Due to the complexity of such evaluations, prospective clients require the help of an objective third-party vendor (with the resources in place) to conduct a thorough level of evaluation of each task being provided by OCIO organizations.

RVK has developed a robust database of over 80 OCIO providers in the marketplace. We remain in regular contact with leading OCIO providers to understand industry best practices across service offerings, fees, and performance. In addition to our OCIO database, RVK has developed a proprietary OCIO evaluation system that reflects the range of services provided in an OCIO relationship. We have defined six broad evaluation categories: organizational structure, personnel, investment process, operations, expenses, and investment performance. Each broad category has a number of subcategories that we feel are important in the assessment of which OCIO provider is best aligned to serve the needs of a specific institution.

Elaborating further on each category, sample questions that we deem important for ERISA Plans to evaluate in an OCIO candidate include the following:

- Organization Structure:
    - Does the firm have a focus on the management of corporate pension assets, particularly plans of similar structure (i.e. open/closed, cash balance and/or implementing a LDI framework)?
    - Is the firm free of conflicts of interest? Are proprietary products used in client solutions? What are the firm guidelines in terms of soft dollar practices, trading with affiliated brokers, or use of custodian or other affiliated entities?
- Personnel:
    - Are the assigned personnel experienced in the management of investment portfolios relative to a liability?
    - Are there experienced actuaries working with the portfolio managers to define the ongoing relationship between assets and liabilities?
- Investment Process:
    - Does the OCIO present clear evidence of a sound investment process, including the ability to develop investment policy and objectives with the Plan Sponsor, set asset allocation in accordance with plan objectives, analyze liabilities, develop custom liability benchmarks, and develop/monitor/execute a glide path?
    - Is there evidence of a differentiated process for evaluating, selecting, and monitoring investment managers, including a sound process for manager replacement within the portfolio?
- Operations:
    - Can the provider consolidate, streamline, and centralize reports from underlying investment managers to meet the ongoing reporting needs of the client?
    - Is there clear evidence they can handle the operations of a defined benefit plan based on the depth and breadth of their operational personnel?
- Expenses:
    - Does the expense structure align with the needs of the client?

- Are clients provided full transparency of total expenses, including underlying manager fees, custody, and other expenses?

- Investment Performance:
  - How does performance, both at the total fund and asset class level, compare to the stated objectives of similar clients?
  - Is there comfort in the length of the performance track record?

RVK has the ability to draw upon the resources of our firm to evaluate each area at a level of detail that clients are often not able to achieve on their own. We also attempt to provide an "apples to apples" comparison of different OCIO firms, including firms with very different business models and philosophies, which otherwise can be very difficult to do without meaningful resources.

Current Trends in the OCIO Marketplace

The OCIO marketplace continues to expand, both in terms of new providers entering the market as well as additional plans deciding to outsource the implementation of their investments. OCIO firms are also increasing their internal resources to meet the growing demand of new clients and an expanding industry. Providers that previously had a limited number of in-house actuaries are increasing this capability to better service ERISA Plans. OCIO firms are also increasing internal counsel, operational capabilities, and manager research functions in an attempt to remain competitive in the growing market.

Initially, demand for OCIO services was primarily driven by frozen plans that wanted to focus fewer Staff resources on the frozen plans, including the day-to-day tactical allocation and execution of investments. The market has evolved further that open plans are now looking to outsource as well based on portfolio and market complexity, or consideration of Staff resources. Pension plans that follow a glide path are also increasingly looking to outsource the management of assets relative to the glide path and partnering with an OCIO provider that has experience in developing an investment policy statement that relates to funded status, rather than purely on risk/return attributes to drive asset allocation. The size of pension plans that are choosing to outsource is steadily increasing with plans in excess of $5 billion considering the OCIO model.

The one key similarity across trends is that mandates are becoming increasingly more customized. Largely due to this high level of customization, there is no published peer universe for OCIO providers to be benchmarked against and thus no uniform benchmark exists to measure the success (or lack thereof) of an OCIO.

Suggested Best Practices and DOL Recommendations

We believe the first step in following best practice is for Plan Sponsors to fully consider the reasons for considering outsourcing investment implementation. This includes evaluating the goals and objectives of the plan, plan status, Staff resources, and Committee preferences on the degree of desired involvement in investment decisions. While an OCIO provider may be beneficial for many plans, it is not a one-size-fits-all solution and should be carefully considered before pursued.

Under an OCIO relationship, the development of strategic direction of the plan must be retained by the Plan Sponsor and cannot be delegated to an OCIO. The OCIO provider's responsibility is to implement the investments, including manager selection and asset allocation within stated policy bands, as well as provide operational support for investments. The OCIO will provide ongoing monitoring of investments within the plan, but the Sponsor retains fiduciary duty over the monitoring of the OCIO provider. While there are challenges inherent in performance benchmarking based on the high degree of customization of OCIO mandates, as a fiduciary, a Plan Sponsor must identify acceptable performance standards and monitor the provider against such standards. The Sponsor should also monitor the OCIO's adherence to stated objectives and constraints outlined in the investment policy statement, as well as the appropriate level of service to meet the agreed upon investment and operational needs.

We recommend that the DOL consider the following:

- Make education available to Plan Sponsors on the OCIO marketplace. We believe that it is imperative for Plan Sponsors to have the proper education to fully understand the OCIO model, the considerations in hiring an OCIO, and the necessary tools to evaluate an OCIO provider.
- Set ongoing monitoring standards. While Plan Sponsors can outsource investment implementation, the fiduciary responsibility of ongoing monitoring remains. There should be minimum standards under ERISA in which a Sponsor can utilize to properly monitor outsourced service providers.
- Encourage a development of better benchmarks and a uniform level of transparency across OCIO providers. While the service offering is highly customized, the development of standard benchmarks may aide in the ongoing monitoring across OCIO firms.

Conclusion

As I mentioned in my opening comments, there are many functional areas in which ERISA Plans can outsource. I hope that my testimony was informative in providing additional clarity of the outsourced-CIO, or OCIO, industry as a potential area for plans to explore that wish to outsource the full implementation of investment decisions. However, although a Plan Sponsor can outsource the implementation, the fiduciary duty of plan oversight and monitoring of outsourced providers remains internal. Proper education and guidance regarding the ongoing monitoring of OCIO providers is an important topic that we believe should continue to be discussed within the investment community.

Thank you again for the opportunity to address you on these issues. If you have any questions or areas in which you would like me to elaborate, I'm happy to address those now. Please also feel free to follow-up via email at Kristen.Steffens@rvkuhns.com or email the broader RVK OCIO Search team at OCIOSearch@rvkuhns.com.