MEETING TODAY'S CHALLENGES WITH OUTSOURCED INVESTMENT SOLUTIONS

From soaring market volatility to an increasingly complex regulatory environment, the challenges confronting institutional asset owners have never been greater. It comes as no surprise, then, that many pension plans, endowments, foundations and other investors are searching for new ways to achieve their investment objectives while controlling risk and keeping costs down.

A growing number of institutional asset owners are discovering the benefits of outsourcing all or part of their investment management functions. An attractive alternative to in-house asset management and traditional consultant models, outsourced investment solutions can provide an effective way for institutions to enhance their investment capabilities and gain much-needed fiduciary support.

INSTITUTIONAL ASSET OWNERS FACE A CHALLENGING ENVIRONMENT

The capital markets landscape is undergoing profound changes, and staggering demands are being placed on today's institutional asset owners and investment committees. These pressures have been amplified by the impact of the 2008 market meltdown. Among the most significant challenges and obstacles are:

- More volatile and difficult financial markets
- Proliferation of complex investment strategies and products
- Expanding research requirements
- Growing scope and scale of risk management oversight needs
- The need for ease and speed in implementing new or different investment solutions
- Increasingly complicated regulations
- Limited budget resources
- Heightened demand for specialized investment capability

It's no wonder that "fiduciary fatigue" has set in as investment committees and in-house asset management professionals cope with the challenges of today's investment environment. And life is likely to get even more difficult in the days ahead. For many institutional investors, the timing couldn't be better to consider outsourcing their investment functions.

OUTSOURCED INVESTING — A FLEXIBLE SOLUTION FOR INSTITUTIONAL INVESTORS

Outsourced investing is about delegating authority. Specifically, it involves transferring discretionary investment responsibility for some or all investment functions from the asset owner to an investment manager or advisor, often called an OCIO (outsourced chief investment officer). Outsourced investing has been used by institutional investors for decades.

PNC INSTITUTIONAL ADVISORY SOLUTIONS

Outsourced investment solutions provide institutional asset owners with flexibility and a wide range of options for delegating investment authority. The scope of outsourcing can vary significantly depending on the needs of a client. The OCIO may have responsibility for the entire portfolio, or the asset owner may designate certain asset classes to be outsourced, e.g., hedge funds and specialty strategies. The specific functions delegated to the investment manager can vary as well: The asset owner may outsource virtually all investment functions or choose among certain responsibilities to be outsourced. For example, institutions may choose to delegate full responsibility for asset allocation and manager selection to an OCIO or they may retain approval authority. Of course, even if all investment functions are fully outsourced, the institutional investor continues to have fiduciary responsibility for the selection and monitoring of the OCIO and overall oversight of the portfolio. But delegation of a portfolio or function to a qualified OCIO provider can help the institutional investor demonstrate a prudent investment process, which can help mitigate fiduciary liability should unexpected market events or portfolio losses occur.

OUTSOURCED INVESTMENT SOLUTIONS — RANGE OF OPTIONS

Type	Description*
Full	▪ Most of the portfolio's investment functions are delegated. ▪ OCIO makes investment decisions within established guidelines, e.g., manager selection, asset allocation, monitoring and asset/liability management.
Hybrid	▪ Institutional asset owner maintains certain higher-level functions, which may include asset/liability management, asset allocation, and IPS construction and maintenance, for example. ▪ OCIO is responsible for implementation and decisions on manager selection and tactical allocations.
Limited	▪ Outsourced investments are limited to specific strategies.

*Descriptions are for illustrative purposes; OCIO models are flexible and may be constructed in many forms.

OUTSOURCED INVESTMENTS VERSUS TRADITIONAL CONSULTANTS

While traditional consulting services encompass the same functions as outsourced investing, there are significant differences between the two. In the traditional consultant model, the asset owner or investment committee contracts with a consultant to provide services such as advising on the investment policy statement (IPS), developing recommendations for investment portfolio composition, recommending investment managers, monitoring performance, and implementing decisions made by the asset owner or investment committee. Under this model, the asset owner, in-house staff or investment committee makes the final decisions after the consultant provides information and makes recommendations.

TRADITIONAL CONSULTING AND OUTSOURCED INVESTMENT MODELS — EXAMPLES

Fiduciary Responsibility/Function	Traditional Consulting	Hybrid (Implemented Consulting)	Full Discretionary Management
Governance	■	■	■
IPS Construction & Maintenance	■	■	■
Asset/Liability Management & Review	■	■	●
Asset Allocation	■	■	●
Investment Structure	■	●	●
Manager Selection, Monitoring & Oversight	■	●	●
Implementation	■	●	●

■ *Client decision* ● *Outsourced decision*

Outsourced Assets Top $1.2 Trillion

In 2014, $1.206 trillion in institutional assets were being managed globally on a full or partially discretionary basis — up from $955 billion a year earlier.

Source: *Pensions & Investments*, survey of investment outsourcers as of March 31, 2014 (published July 2014)

THE INSTITUTIONAL MARKET FOR OCIO SOLUTIONS

Outsourced investing can be an attractive alternative for a variety of asset owners, including:

- Public defined benefit plans
- Corporate defined benefit plans
- Foundations
- Taft-Hartley defined benefit plans
- Endowments

INSTITUTIONAL INVESTORS OF ALL SIZES ARE USING OUTSOURCED INVESTING

A wide range of institutional investors are now outsourcing some or all of their investment functions. According to the 208 asset owners included in the 2015 Outsourced-Chief Investment Officer Survey (*CIO*, February 27, 2015), use of the OCIO model is widespread:

- More than half of the institutional investors surveyed with assets of $1 billion or less indicated that they either outsource now or plan to outsource. Of the largest asset owners (in excess of $15 billion), 35% said they are outsourcing investment functions now or intend to do so in the future.
- Over half (57%) of the institutions that outsource handed over their entire portfolio to third-party managers — an increase of nine percentage points from the prior year.
- From the largest asset owners to the smallest, investment teams that outsource have shrunk in size. The average size of an institutional investor's internal team that outsourced was seven people in January 2015, compared with 11 at the same time in 2014.

2015 OUTSOURCED-CHIEF INVESTMENT OFFICER SURVEY
Total Investable Portfolio/Staffing Resources/Outsourcing Situation

Portfolio	Avg Size of Investment Staff	% That Outsource / Plan To
<$100MM	1	68%
$100MM–$500MM	1	57%
$500MM–$1B	2	64%
$1B–$5B	4	27%
$5B–$15B	10	16%
>$15B	41	35%

Source: www.ai-cfo.com/surveys

ADVANTAGES OF OUTSOURCED INVESTMENT SOLUTIONS

Outsourced investment solutions offer institutional asset owners a number of potential advantages.

1. **Agile decision making.** Since the outsourced investment model delegates authority for designated functions, the OCIO provider can make fast decisions in response to changing conditions. The traditional consulting approach often involves providing information and recommendations to in-house staff or the investment committee, who are then responsible for making the final decisions. This process takes time, perhaps causing the institutional asset owner to miss opportunities that could have enabled them to optimize their portfolio structure. Outsourced investment providers, on the other hand, are able to make faster decisions and move more quickly on implementation. Importantly, this enhanced agility that the OCIO model offers can help significantly reduce the costs associated with missed opportunities.

2. **More sophisticated investment strategies.** The challenging investment environment is causing institutional investors to explore increasingly sophisticated investment strategies. Absolute return and other alternative products provide the opportunity for return and diversification, as do opportunistic strategies such as macro hedge funds, distressed debt, bank loans and long-short products. Evaluating the risk–return implications of these options can push staff and investment committees beyond the limits of their skill sets. An OCIO provider can provide the experience to implement multifaceted solutions to help enhance the potential of the asset owner's portfolio.

ADVANTAGES OF FULL OCIO SOLUTION

1. Agile decision making
2. More sophisticated investment strategies
3. Better allocation of resources
4. Improved risk management and fiduciary oversight
5. Opportunity for cost savings
6. Enhanced reporting

3. **Better allocation of resources.** Outsourced investment solutions enable institutional investors to optimally allocate scarce resources. Since an OCIO is responsible for decision-making within the scope of the delegated investment functions, the institutional asset owner can focus on higher-order investment policy matters and on overseeing overall performance, liquidity and risk, as well as on other business priorities. As a result, investors can avoid allocating limited resources to functions that may be more effectively performed by outsourced investment providers.

4. **Improved risk management and fiduciary oversight.** Seasoned OCIO providers have developed sophisticated tools to help manage portfolio risk and effectively deploy the client's risk budget. In addition, outsourced investment firms have established exacting due diligence and monitoring systems to evaluate third-party managers, enabling them to select best-in-class strategies and — if needed — change managers. Outsourced solutions also provide institutional asset owners with a wide range of options for

delegating discretionary investment authority, providing institutions with the ability to shift some of their fiduciary responsibilities.

5. **Opportunity for cost savings.** Because of scale efficiencies, outsourcing can provide investors with cost savings in implementing portfolio strategies. An OCIO firm has the opportunity to pool assets of several investors, thus enabling a single asset owner to gain access to managers and strategies that it otherwise might not be able to use because of account minimums. Pooling of investor assets also enables the OCIO firm to negotiate better terms with specialist managers as well as the ability to achieve less expensive executions because of larger transaction sizes.

6. **Enhanced reporting.** Today's complicated investment climate demands sophisticated communications and reporting. To be effective, information should be distilled and presented in a way that is responsive to institutional asset owners' needs and customized to address the unique priorities of each. OCIO firms are able to combine a wide range of investment strategies into a reporting format and deliver meaningful, understandable insights. OCIO reporting also benefits institutional investors by freeing up internal resources that would be devoted to routine report preparation.

2015 OUTSOURCED-CHIEF INVESTMENT OFFICER SURVEY / Reasons for Outsourcing

	Critical	Important	Not Very Important	Not At All Important	Not Applicable
Better risk management	40%	49%	4%	5%	2%
Cost savings	9%	51%	21%	9%	10%
Lack of internal resources	51%	35%	11%	0%	3%
Additional fiduciary oversight	32%	35%	25%	4%	4%
Need to increase returns	9%	56%	21%	11%	3%
Faster implementation/decisions	23%	42%	23%	7%	5%
Desire for strategic partnership	9%	32%	35%	19%	5%

Source: www.ai-cfo.com/surveys

IMPLEMENTING AN OCIO SOLUTION

Once an institutional investor decides that an outsourcing approach is appropriate for its portfolio, the next step is to define the framework within which an OCIO provider will be selected and then operate. While the specifics will vary depending on each institution's needs, the following considerations are important elements in the initial stages of an OCIO relationship:

- Decide the extent of outsourced solution being sought — full, hybrid, single-strategy.
- Define accountability for all investment functions, including those that are retained.
- Establish the level of delegation of functions being outsourced and the desired fiduciary accountability for each.
- Specify how each participant in the investment function — in-house staff, investment committee, consultant and outsourced investment provider — is to interact with the others.
- Establish a risk budget with definitions of volatility, downside exposure and other key measures.
- Set guidelines, tactical positions and ranges within which the OCIO is expected to perform.
- Define performance expectations, benchmarks and metrics to use in evaluating an OCIO's performance.
- Determine reporting requirements for OCIO.
- Establish criteria for selecting an OCIO provider.
- Compose due diligence questions and areas to examine (see "OCIO Selection: Due Diligence Questions").
- Engage in Request for Proposal (RFP) process, perhaps with the assistance of a traditional consultant.

OCIO SELECTION: DUE DILIGENCE QUESTIONS

GENERAL

- Describe your organization and capabilities, including personnel and experience.
- How long have you provided OCIO services? How have your OCIO services changed and improved over time?
- What is the size and composition of your OCIO client base? How many clients are similar to us in terms of size and goals?

PHILOSOPHY AND PROCESS

- Describe your investment philosophy, strategy and process.
- What is your process for determining an appropriate asset mix for an institution?
- How often do you make strategic and tactical portfolio changes? Can you give examples that illustrate how you take advantage of market opportunities?
- Describe your process for evaluating managers, including original due diligence and monitoring.
- How often do you terminate managers? How do you handle firings?
- Do you work with us to design a customized outsourced investment solution or do you offer only a one-size-fits-all solution?
- Demonstrate your ability to coordinate multi-discipline asset managers.

RISK/MONITORING

- How do you monitor and analyze risk? What tools and resources are utilized?
- How do you analyze strategies to confirm that managers do not overlap in terms of holdings and concentrations?
- Will you acknowledge your fiduciary status as OCIO in writing?
- What indemnifications do you offer? [Does PNC provide indemnification in this context?] What are your bonding and insurance coverage levels?
- Describe your conflict of interest policy and how you confirm compliance.

REPORTING/COMMUNICATIONS

- Describe your reporting capabilities and how multi-discipline managers are integrated.
- Do you have the flexibility to design a reporting structure that addresses our specific interests?
- How do you apprise us of important events related to our portfolio and developments at your firm or managers in our portfolio?

FEES

- Provide a fee schedule and description of all investment and related expenses for your OCIO model.

Institutional asset owners of all sizes are choosing to outsource all or parts of their investment functions. The OCIO model can provide investors with a compelling combination of investment experience, cost effectiveness, nimble decision-making, and the ability to take advantage of more sophisticated strategies — all while providing fiduciary relief.

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