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The OCIO Movement: The Growth (or Rebirth?) of Discretionary Investment Fiduciaries

The term "outsourced chief investment officer" or OCIO has come into vogue over the past decade, and the rise of OCIOs and 3(38) investment managers reflects a larger trend of the growth of fully discretionary investment services. This column examines the evolution of fiduciary investment discretion in general and the OCIO movement in particular.

By Pete Swisher

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A Random Walk Through OCIO and 3(38) History

In 2007, at a presentation for qualified plan investment specialists, I posed the question, "Who in the audience knows what an ERISA section 3(38) investment manager is?" Crickets. In a room of about 200 people, not one person raised a hand. I assume a few people were sandbagging, but the point stands that even the term "3(38)" was virtually unknown in the retirement plan community just 12 years ago. Today, obviously, Section 3(38) investment management is a thing. Everyone in the retirement plan world either does it, claims to do it, or talks about it.

Fast forward to 2011. An experienced qualified plan advisor asks, "Are you a 3(28) or a 3(31)?" and repeats the same numbers enough times that this was clearly not a slip of the tongue. He knew enough to know that he was supposed to know something, but not enough to know the correct references (i.e., Employee Retirement Income Security Act of 1974, as amended (ERISA) §§ 3(38) and 3(21)).

Fast forward again to early 2018. A top-tier advisor says, "A few years ago I said we were not doing 3(38) because our clients preferred to retain discretion. Two years ago, I think we had exactly one 3(38) client. Today I'm planning on converting almost my entire book of business to 3(38)."

Now rewind to 1988 or so and the founding of investment adviser Hirtle, Callaghan & Co., which is widely credited with being the first to coin the term—and champion the business model—of the Outsourced Chief Investment Officer (OCIO). The notion is that an OCIO takes discretion for the overall management of a foundation, endowment, qualified plan, or other pool of assets on behalf of the asset owner. Instead of simply consulting with asset owners on strategic asset allocation and manager searches, the OCIO accepts discretion for the entire investment puzzle. And instead of hiring and managing an in-house investment team, the asset owner outsources the entire investment function.

Rewind further to the early 20th century. The modern financial industry does not exist, and professional, discretionary money management is almost solely the province of bank trustees. There is a reason why modern non-ERISA fiduciary law is called "the common law of trusts." During the balance of the century, as modern money management unfolded:

- There was more wealth, calling for more wealth management.
- Financial salespeople grew in numbers—brokers, insurance agents, and investment advisers.
- Bank trustees went from having 90 percent or more of the investment management trade to having a small minority—not because they lost the business, but because the business and the competition grew faster.
- Legislation and regulation expanded to constrain the baser impulses of the growing financial industry.
- Mega-asset pools arose, leading to the hiring of Chief Investment Officers (CIOs) and investment staffs to manage those pools.
- The global financial crisis of 2008-2009 caused a growing number of pensions, foundations, and endowments to outsource the CIO role to an OCIO.
- In recent years, qualified plan advisors moved rapidly toward a fee-based, fiduciary model, and service as a 3(38) investment manager became increasingly common.
- The trend today is toward fiduciary advice, fiduciary management, and OCIO services. Discretionary fiduciary services are on the rise.

So discretionary fiduciary management used to be the only game in town, because bank trustees were the only fiduciary asset managers, more or less. The modern financial industry led to a great diversity of money management options, including self-direction and the modern suite of financial products for sale by non-fiduciaries. But the trend today is toward an increasing number of asset pools hiring a discretionary investment manager, under various names—including OCIO, 3(38), discretionary trustee, "delegated management," "fiduciary management," and "implemented consulting." But the catchiest label in the United States seems to be OCIO.

The OCIO Landscape

OCIO could be categorized in multiple ways: (1) by the types of firms that provide OCIO services, for example, independent registered investment adviser (RIA) or consultant, wirehouse broker-dealer "BD"/RIA complex, mutual fund family, family office, bank trustee; (2) by the types of accounts served, for example, retirement plan, foundations, endowments, other large pools of capital; or (3) by the scope of services (full investment discretion versus shades of partial discretion).

"OCIO" is a marketing term, and there are no rules limiting its use, but we can broadly define an OCIO as an asset manager with full discretion (though not without client oversight and input) over both asset allocation and asset selection, often including control over a wide range of alternative asset types. Below are vignettes of the types of firms that offer OCIO services.

Family Office. A family office manages the joint assets of the wealthy family members. For example, one family office business caters to a handful of professional athletes. They buy direct ownership in businesses, shares of private equity and private debt funds, and other alternative investments on behalf of their clients, as well as more mundane assets like mutual funds. According to the Family Office Exchange [familyoffice.com], there are roughly 6,000 single family offices in the United States (and more overseas), plus many multi-family offices like the one in this example. Many of the family offices have discretion over management of the family's assets, although many simply advise and assist. Many family offices are "in house" CIOs for the families they serve, but many others either hire OCIOs or view themselves as being the OCIO.

ERISA Investment Managers. In plans covered by ERISA, "OCIO" has generally not been used to describe investment managers other than in large defined benefit plans or specialized pooled trusts. In defined contribution plans, a discretionary investment manager is usually described as either an ERISA Section 3(38) investment manager or a discretionary trustee, but "OCIO" is used occasionally, and use of the term is growing among large plans.

Discretion is on the rise in ERISA plans of all types, with large 3(38) managers reporting significant growth in the portion of assets under service over which they have full investment discretion. Request for Proposals (RFPs) for advisor services now routinely ask for discretionary versus non-discretionary pricing, and clients choose the discretionary offering with increasing frequency.

Specialty OCIO Shops. The author's firm was founded in the 1940s to manage the multiple employer pension program of the Federal Home Loan Bank system and, later, the bank and credit union community at large, and continues to act as the program's OCIO today. The National Rural Electric Cooperative Association (NRECA) manages large health care and retirement trusts for its members. These are specialized firms created to manage specific pools of capital on behalf of the asset owners.

RIA Offering OCIO Search Services. One adviser whose firm does not itself serve as an OCIO offers OCIO search services on a project basis. He has this to say about the OCIO search consulting landscape: "We offer 3(38) services to defined contribution plans," but not OCIO services for foundations, endowments, and pension plans. "But we get several requests per year from clients about OCIO. We, therefore, began offering search services as a way to help our clients." The adviser does three to four searches per year and reports, "There are probably 100 or so firms out there doing a handful of searches per year like us."

Large Consultants. Larger national and global firms with substantial OCIO practices compete for the largest mandates, such as multi-billion-dollar municipal pension plans and large foundations and endowments. Such firms offer search services, but also compete for the services themselves—always an interesting dynamic for the consulting world, where the long-term engagement is worth far more than the one-time search.

Project-Only Consultants. Specialized consultants that accept only project-based work are few and far between, because there is only so much project work to go around. But there are a handful of such firms doing OCIO, investment manager, advisor, and record-keeper searches and benchmarking on a full-time basis.

Wirehouses. Large BD/RIA (broker-dealer/registered investment adviser) complexes offer various discretionary services, including fiduciary management services via their RIA arms, and compete actively for OCIO engagements.

Fund Families. Discretionary management is at the heart of what a fund family is, so fund complexes are also competing for OCIO business. Fund family offerings in the OCIO space parallel the investment management that the firm already does, and may include the fund family's existing products.

Examples of OCIO Clients

Chief Investment Officer [*www.ai-cio.com*] magazine reports on the OCIO industry, including wins and losses, such as:

- Two charitable foundations, one with $73 million and the other with $120 million
- A municipal pension plan with $12 billion (which went from having an in-house CIO to outsourced CIO then back to in-house a few years later)
- A large university's $363 million endowment
- A $50 million high school endowment, and
- A multinational corporation's $4 billion corporate fund.

These are sizeable clients and thus more likely to be publicly reported. Nonetheless, most OCIO clients are smaller, although the industry is institutional—these are clients with anywhere from tens of millions to billions of dollars in assets.

Conflicts of Interest?

There are several arrangements in the ERISA world that are sometimes incorrectly identified as prohibited conflicts of interest, and the same is true in the non-ERISA world. The argument goes like this:

- "A discretionary trustee cannot choose itself to be the 3(38) investment manager."

- "A fund family chosen to be an OCIO can't choose its own funds for the portfolio."

The assertion is that these are ERISA-prohibited transactions or otherwise impermissible conflicts of interest. The implication is that an OCIO has been hired to pick funds or managers as an independent fiduciary, and, therefore, cannot choose its own funds or appoint itself to provide management services. As stated, of course, this is true: An ERISA fiduciary cannot simply appoint itself to provide services for additional compensation. {DOL Reg. § 2550.408b-2(e)} But the notion that an investment manager or discretionary trustee—someone who has been hired to manage money—is required to hire another investment manager to do the actual investing is silly, both legally and practically. This does not mean the use of proprietary products raises no conflict of interest issues—only that it is false to assert that a manager cannot manage using its existing management products.

Another way of looking at the situation is that an OCIO is hired to manage assets, whether through choosing individual securities or hiring other managers. There is no obligation to hire others versus doing the work oneself. In fact, it is only recently—since about the 1950s, with the advent of the *Restatement of the Law Second, Trusts* (published by the American Law Institute)—that it began to be recognized that a trustee was even *permitted* to hire other professionals. It was actually a tenet of the common law in past centuries that a trustee was legally obligated to do the work itself.

In short, if the engagement is "Choose funds in your capacity as an independent fiduciary," of course, it is a conflict to choose one's own funds. But if the engagement is "Manage this money," there is a legal path to the use of one's own management products (such as revenue neutrality along the lines of the mechanism laid out in the Country Trust Letter, DOL Advisory Opinion 2005-10A). Similarly, a discretionary trustee is permitted, but certainly not obligated, to hire an investment manager.

Conflicts in Advisor or OCIO Searches

Advisors help retirement plan sponsors with due diligence on other vendors, but who helps the employer with due diligence on the advisor? Who watches the watchmen? Some advisors excel at shedding light on other vendors, but seem to avoid the spotlight themselves. This issue is a dilemma for all parties:

- Employers or asset owners appreciate the help of a professional advisor, but as one medium-sized 401(k) sponsor once said, "I understand the need for all this due diligence stuff, but I'm really not interested in hiring another advisor to advise on my advisor. Enough is enough." Yet due diligence on the advisor is clearly required under ERISA. {ERISA § 404(a)(1)(B)}
- Advisors that want to help employers with "advice about the advisor" need a compliant path for doing so—an approach that puts the client in charge so as to eliminate or mitigate conflicts, yet provides clients with enough assistance so that they need not reinvent the wheel. Common approaches to this are for the advisor to provide a sample RFP or benchmarking information to the employer, to enable the employer to do the search itself. Yet, in many cases, clients want more: They want someone to take care of the entire RFP process.
- Most advisors want the long-term engagement, not the one-time project, but the very fact that a firm is known as a credible OCIO or 3(38) manager means that they may be uniquely qualified to conduct the search. However, not every advisor is willing to take on this lesser role, much less make that a large part of its practice.

Conducting an RFP and submitting oneself as a candidate in the search is a clear and classic conflict of interest—though careful lawyering might actually make the conflict legally permissible. But OCIO engagements are large, institutional arrangements that warrant a great deal of care. Thus, the use of project-only consultants is common in OCIO searches, as the examples above illustrate, and many OCIO providers have become willing to do project-only work.

The Future of Outsourcing

Discretionary investment management is on the rise as part of a larger trend toward outsourcing of fiduciary responsibilities. In hindsight, this is an obvious and logical consequence in the United States of moving from a national retirement system consisting of a handful of unfunded pension promises just 80 years ago to the $28 trillion pool of "other people's money" that it is today. It is also a logical consequence of the growth in global wealth. In today's environment of growing regulation and litigation, and given the scale of the responsibility, it makes sense that clients increasingly will turn to those willing to accept full responsibility for choices rather than simply assisting with a client's own fiduciary decisions. In other words, the breadth of fiduciary responsibility and the consequences of breaching that responsibility are significant forces behind the rapidly growing outsourcing movement.

Another factor often cited in client decisions to outsource might be described as "mindspace." Businesses and other organizations want to focus on their core mission; they do not want their key people devoting time and mental energy to non-core functions, especially when those functions require expertise and carry risks. In that context, it makes sense to leave investing to people who do that work full time, and let the widget-makers make widgets.

Another driver of the movement to OCIO and 3(38) is the recognition that even a very large asset owner—such as a $10 billion pension fund—cannot hope to match the breadth and depth of capability of a manager with $200 billion or more under management. And the typical OCIO client manages less than the large asset owner, struggling to compete even with the capabilities of a manager of as little as $2 billion in assets. While managing assets in-house may be cheaper in fee outlay, scale can bring capabilities (and outcomes) that trump explicit cost.

The final driver is complexity. The investment landscape has changed radically over the past century. The typical discretionary investment manager in 1920 was a bank trustee holding portfolios made up exclusively of individual bonds and perhaps some inherited real estate—no stocks, no options, no hedge funds, no private debt or equity. The modern OCIO is balancing streams of future cash flows against pools of diverse, incredibly complex financial instruments. Complexity calls for specialists, and diversification calls for teams of specialists. An in-house CIO might feel that he or she can choose the overall asset allocation and simply hire the specialists as needed, but asset owners in increasing numbers are opting for full outsourcing of investment decisions.

Conclusion

Complexity, scale, the demands of fiduciary responsibility, and a growing unwillingness to suffer distractions—these are the drivers behind the rising movement toward OCIO, 3(38) investment management, and other forms of fiduciary outsourcing. The clear future of the movement is that it will grow in both absolute and relative terms. ■