

Managers Step up in Outsourced CIO Fray

Column published on September 9, 2011

Columnist: Paul Menchaca

As the outsourced CIO (OCIO) model picks up more clients, the number of financial services firms launching their own version of the service is also growing – with consultants, asset managers and others vying for a piece of the potentially lucrative business. And managers may end up having an early edge over consulting firms, say some observers.

But while the number of pensions, foundations and endowments looking to outsource their investments is expanding, the space still remains relatively small, and experts say that the hustling for this business is going to grow increasingly competitive. It remains to be seen which of the major players will gain the upper hand among clients.

Success in the OCIO space will largely depend on firms gaining trust among clients as effective, conflicts-free investment officers. But it's also going to come down to capital – or rather, the amount of resources that firms have at their disposal to build their OCIO platform in order to meet clients' needs.

As for dedicated outsourcing firms, Quirk calls them “a defining force” for the entire OCIO market

On this latter point, some experts say that consultants could be at a disadvantage. Consulting firms lack the resources that asset management firms have, says Russell Mason, president of the Investment Management Institute. The market also is getting crowded with the various players, he adds. As more consulting firms launch discretionary businesses, managers are counteracting with their own platforms.

“I think this space is going to get very competitive going forward,” Mason says. “Asset management firms are going to engulf consulting firms that are either in it or thinking about getting in it. Unless [consultants] are willing to put resources behind it, [the asset management firms] are going to eat their lunch. They will beat them at their own game and eat into their assets because [the consulting firms] overreached.”

Mason is not alone in questioning the ability of consultants to effectively compete in the OCIO space.

“Economically, they are struggling tremendously, and because the economics are not very good, it’s hard to attract and retain very good people,” says Kevin Quirk, a founding partner at management consultant Casey Quirk & Associates. “One of the reasons they are developing [an OCIO program] is as a way to solve the economic problems of their business and align their interest with their clients more closely.”

Besides asset management firms and consultants, Quirk says the other two major players in the OCIO space include businesses that operate more like fund of funds – including Commonfund and SEI – and dedicated OCIO firms, such as Hirtle Callaghan, Strategic Investment Group and Agility, which is the outsourcing wing of Perella Weinberg Partners.

“These other business models probably have the ability to put more money [than consultants] into outsourcing, as well,” Quirk says.

In 2008, Casey Quirk released a report in which it estimated the OCIO business would grow to \$510 billion by 2012, representing 13% of assets and 25% of investors. But the firm has recently updated the data, and forecasts a slightly slower pace of growth – to \$480 billion by 2015.

Quirk, though, says his firm remains “bullish” on the outsourced market. He estimates that corporate pensions, foundations and endowments will have half a trillion dollars in the outsourced space in the next couple of years. He also says that the types of institutional investors utilizing OCIO programs are “trending larger” than was the case several years ago.

“We think it’s going to grow a lot, but it’s still only a portion of the overall market,” Quirk says.

Besides the financial disadvantage that consulting firms appear to have in the OCIO space, Quirk says that they must also earn credibility as money managers, given that they are known only as advisors.

Consultants are not the only ones who still have to prove themselves to potential clients, according to Quirk. While asset management firms have capital to go along with credibility as money managers, Quirk says that these firms face two challenges in their efforts to win OCIO business.

First, they must prove their willingness to offer wider investment options to clients, because many asset management firms market only proprietary investment products.

The other drawback for managers is scale, Quirk says: “It’s also a very, very small part of their overall business. The market itself will have to grow

tremendously in order for them to put a focus on it and grow it. But right now, it's not critically important to their overall business."

As for the fund-of-funds approach to outsourcing, Quirk says these firms are well positioned because "first and foremost, they have been running money, typically on a third-party business platform, and so they have an aura of independence and have got a lot of clients built up over time." But, he adds, these firms are operating as "primarily a product and sales model" and historically have not been involved in customized outsourcing relationships with clients.

As for dedicated outsourcing firms, Quirk calls them "a defining force" for the entire OCIO market. Not only are they the most mature and well developed, but they have been able to poach well-known CIOs from the endowment world to help lead their efforts.

"They have caused the most change in the industry, made the most noise, and they have gone at it in a singularly and focused way," Quirk says.

Charles Skorina, president of an eponymous executive search firm in San Francisco, says that an important factor in determining a firm's ability to grow its OCIO business is its ability to "speak the language of the client." In other words, when a consultant or a CIO outsourcer is talking to an endowment, it helps to know the problems that endowments encounter, including the cycle of payouts and the nature of university operations.

"It sounds obvious, but it isn't always," Skorina says.

The story about the rise of the OCIO platform has perhaps been a bit overstated thus far, since it still has a small share of the overall asset management business, Skorina says. But, he adds, the growth potential is definitely there.

"I do think it's a little bit overblown, but the key is whether public pensions will be allowed to outsource," Skorina says. "If they could outsource, that would be the harbinger. Those are the most conservative investors, but huge in terms of money. That's the holy grail."