FUNDfire

Outsourcing Biz Will Change Life for Managers

December 1, 2010

By **Paul O'Dowd**

It won't be long before investment managers will likely have to tweak their business model to favor the ever-growing discretionary advice industry. While that day is not yet here, firms are picking up on the shift of institutions moving from traditional consulting to the newer outsourced model that gives consultants decision-making authority over investments.

Among the most important changes that will likely occur for managers is the diminishing importance of having a knock-down, take-no-prisoners finals presentation team in house.

"Corporate defined benefit funds have been closing and getting frozen [for some time now]," says Paul Klauder, a managing director within SEI's global institutional group. "Now, this is more of a legacy benefit rather than an ongoing benefit." At this point, Klauder says, some members of a corporate pension's investment staff question their roles at the company.

The discretionary business, which is similar to the multi-manager and outsourced CIO models in that an institution can outsource part or all of its investment portfolio to a third party, has really begun to pick up steam in recent years. Most investors that choose this model have between $25 million to $2 billion in assets, and that asset number will continue to move higher over coming years, experts say.

"The market events of 2008 scared investors," says Kim Wood, Mercer's U.S. leader for implemented consulting. "Investments that were really supposed to offset each other moved down in tandem," she says, adding that the turbulent markets caused some investors to look elsewhere for help.

One main reason for this shift, she says, is lack of institutional resources, particularly at smaller public and corporate pension funds. Many smaller public pensions now would rather outsource over building an internal investment staff, while corporations have to choose whether to invest resources in managing the pension or putting the money back into the business, says Wood. Oftentimes, the business end wins.

The other big reason for the shift has to do with manager termination and selection. Consultants with discretionary capabilities can typically terminate a manager in timely fashion when there is an adverse event, such as a senior portfolio manager or CIO defection. With the traditional consulting model, a pension may wait a month or several months until the next investment meeting to terminate a firm. The discretionary method allows for "more proactive" movement, Wood says.

Similarly, on the hiring side, a manager with a strong track record can instantly be plugged into an open mandate without an arduous and drawn-out RFP process.

“This is a serious trend, one that will persist for years to come,” says Greg Mulready, director of sales, marketing and client services at Lee Munder Capital Group, speaking of the growing discretionary business.

“That doesn’t change our business model, however, too much,” he says, at least not now. “We have always gone directly to consultants and that won’t change.”

Mulready says he believes the majority of searches will continue to be run through RFPs and finals presentation teams for the foreseeable future. But, he says, there certainly is “natural evolution” within the business.

The biggest upside in the discretionary business seems to be from corporations.

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At this point, Klauder says, some members of a corporate pension’s investment staff question their roles at the company. “Historically, these pension executives then wonder to themselves why they are working for a soon-to-be defunct DB pension,” he says. “They may move on.”

When such senior officials move on, the corporation must consider potentially rehiring staff, shifting responsibilities or simply outsourcing the portfolios, with the last option being a popular choice.

As more clients opt for outsourcing, investment managers will have to strengthen their ability to connect to these consultants in a new way.

And it is not just the increasing number of clients boosting the business, but the size of the clients, as well. “We are seeing larger funds looking at our [outsourced] abilities,” says Wood, noting that Mercer has added $7.5 billion in discretionary services since it entered the business nearly a decade ago.