

In Search of an Honest Man

The Case for Investment Outsourcing

By Robert M. Balentine

Investment outsourcing is gaining traction among clients and advisors seeking a transparent and conflict-free business model. By blending the objectivity of a consultant with the discretionary implementation and accountability of a money manager, outsourcing is going mainstream. Since the passage of the Employee Retirement Income Services Act (ERISA) in 1974, there has been inherent tension between consultants offering advice and managers offering implementation. Clients hire managers, but only those managers their consultants recommend. Managers court consultants to gain access to the assets they oversee. Consultants want managers to stay within conventionally defined style boxes and managers want greater flexibility. Unfortunately, too many consultant and manager relationships have been biased by financial favors, directed commissions, conference sponsorships, and other apparent conflicts. The tension also is exacerbated by the fee disparity, with consultants often earning three to five basis points to a manager's 50 to 100 basis points.

Diogenes of Sinope purportedly spent his entire life in ancient Greece in search of an honest man. Believing that virtue was better revealed in action than in theory, his life was a relentless campaign to debunk the social values and institutions of what he saw as a corrupt society. Diogenes' experience is, perhaps, a fitting metaphor for the investment business today. Clients are reeling from a crisis of confidence as trust has eroded. Institutions they once perceived as strong either have fallen by the wayside or become mere shadows of their former selves. Conflicts of interest abound, and fees and disclosures have become more opaque. Investors are seeking a model that is objective, transparent, and aligns the advisor's interest with their own. I believe the outsourced chief investment officer (CIO) is just such a model. And its arrival is none too soon, because just like the ancient Greek cynic, clients are seeking action, not theory.

The Way Forward

"Investment outsourcing" refers to the blending of traditional consulting services with discretionary investment management. It has grown because clients seek to avoid the tension between consultants and managers when advice is separated from implementation. Investment outsourcing, also known as "outsourced chief investment officer," offers the following advantages:

- Clients benefit because less time passes between investment decision and implementation, which is the advisor's

responsibility. Investment committees and families cannot always capture opportunities or strategies when they meet and their consultants present advice only quarterly; indeed, meeting schedules should not determine investment action.

- Centralized implementation allows clients to access best-in-class managers at lower fees using vehicles that commingle their assets with other clients.'
- Flexibility to preserve customized solutions, including the ability to customize around concentrated positions and existing managers or to work with a specific portion of the portfolio such as alternative investments.
- Clients are able to hold their advisors to a higher standard of accountability: They delegate the fiduciary duty of implementation to the advisor so that the advisor takes responsibility for performance.
- Clients can access expert teams and in-depth research, even with smaller asset pools.

The outsourced CIO combines the best of the traditional consultant (objective, conflict-free advice) with the best of the investment manager (the ability to quickly implement insights and accountability for the results). Family offices, foundations, and endowments understand that few have enough resources to compete for talent and build the quality in-house team they could access from outside. The best in our industry thrive in an entrepreneurial, team setting surrounded by bright colleagues, something that is difficult to achieve in a small shop.

Generally, owners or caretakers of financial assets tend to have less expertise in the management of those assets than the professionals who have made a career specifically oriented to their oversight. This leads owners to retain professionals to aid in the management of their wealth. However, the following problems are often present in this relationship:

1. The goals of the owner or principal may differ from the goals of the agent (preserve wealth versus preserve job).
2. The oversight of the agent can be difficult (if owners had the expertise to truly oversee the agents, they could perform the agent task themselves).
3. The definition and acceptance of risk can be very different between owner and agent.

Managing financial assets is as much an exercise in managing risk as it is in managing returns. As in any business, the reward expected for any risk undertaken must be carefully weighed and evaluated. Modern asset management



and investment oversight has become the arena of highly trained and experienced experts because financial systems and instruments have become amazingly complex. With the advent of the information age, investors have more tools than ever before. But information is not knowledge, and knowledge is not wisdom. The majority of owners and caretakers of financial assets are unprepared to manage and oversee wealth in today's financial world. The need for expertise, indeed wisdom, from education to training to hands-on experience, is greater now than at any time in history.

The Trend is Your Friend

Trends in investment management typically begin among larger institutions and slowly evolve, moving downstream to family offices, high-net-worth individuals, and ultimately mutual funds. Consider examples such as asset allocation, open architecture, global investing, and the use of alternative investments. Ironically, this time around, it was the mutual fund industry that pioneered discretionary advice and implementation in a single product. Target date retirement funds now make up more than a third of designated qualified default investment options.

Many leading endowments and foundations have jumped on the outsourced CIO bandwagon. These larger institutions have fueled most of the market's recent growth; the trend remains in its infancy for family office and high-net-worth clients. A December 2008 white paper by Casey Quirk, titled "The New Gatekeepers: Winning Business Models for Investment Outsourcing," estimates the outsourced CIO market will grow to \$510 billion by 2012, representing 13 percent of assets and 25 percent of investors, after having more than doubled the previous four years.¹

A Recipe for Success

The following key ingredients are necessary for successful delivery of an outsourced CIO service:

Access. Clients want access to best-in-class managers and key advisors. Investment performance is generally thought of first, but service is an even bigger issue. There must be a great deal of communication between the asset owners, the advisors, and the managers who implement the advice. This is a highly personalized service where all decisions are made in the context of clients' appetites for risk, cash flow, and liquidity. Service demands a blend of traditional relationship management and access to senior investment officers and technical research personnel.

Fee independence. Advisors need to decouple the fees they charge for advice from the fees paid to implement strategies. Clients should enjoy full transparency over fee structures and feel secure their advisors are not conflicted when recommending an implementation solution. Clearly, the outsourced model does not support an affiliated broker-dealer.


Alignment of interest. An advisor's reputation for objectivity and conflict-free advice and implementation is paramount. Open architecture, independent governance, significant ownership among principals, and co-investment with clients are important to ensure the client and advisor share the same goals.

Visible results. Traditionally, consultants are selected on soft issues such as breadth and depth of services, references, and personal relationships. Investment managers are selected largely on the basis of performance. All of these should be considered when selecting an outsourced solution, but the advisor also must be able to demonstrate a track record.

The "perfect" service should be able to demonstrate the following:

- A list of satisfied clients (referrals)
- An investment team with deep experience as consultants and managers
- Research depth in all asset classes, especially alternative investments
- Superior risk-adjusted investment performance
- Success at selecting top-performing managers
- Success in rebalancing decisions
- Attribution analysis

For the advisor, the outsourced model offers a key advantage over the traditional investment consulting firm—leverage. To understand the economics, consider the traditional investment consulting model where fees are derived from retainers and project fees or a few basis points of assets overseen. Each manager search is begun anew. Decisions are made and implemented only after the client has given express permission. In an outsourced model, advisors are able to create tremendous efficiency by focusing research efforts on their best ideas and then leverage those insights across the client base and efficiently implement them on a discretionary basis.

The outsourced CIO business model is here to stay, and smart advisors will do well to heed the siren call of alignment of interests, transparency, and accountability. After all, if we listen to our clients, they'll surely tell us how to run our businesses. 

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Endnote

¹ Available at http://www.caseyquirk.com/docs/research_insight/The%20New%20Gatekeepers%20-%20December%202008.pdf.

