

Investment outsourcing means *insourcing* investment management best practices

Endowments and Foundations' interest in strategic providers who can offer professional expertise, share fiduciary responsibility and improve governance, continues to grow.

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As the decade 2000–2009 drew to a close, few, if any, institutional investors were sorry to see it go. As *The Wall Street Journal* (December 20, 2009) noted, “In nearly 200 years of recorded stock-market history, no calendar decade has seen such a dismal performance as the 2000s.”

Dramatic growth in investment discretion

In this environment, many in the non-profit sector have been seeking additional help from professionals outside their organization. One of the most visible trends is widely known as investment outsourcing. In a recent study, “The New Gatekeepers: Winning Business Models for Investments Outsourcing,” Casey Quirk defines investment outsourcing as an investor delegating the majority of its assets “... and some level of investment discretion to a third party for a portfolio-based fee.”¹

Casey Quirk notes that the outsourcing of assets more than doubled in the period 2004 through 2008. Although the absolute number of assets declined with the market pullback in 2009, the firm predicts that a quarter of all institutional investors will outsource their investment programs by 2012.²

Enhanced fiduciary solutions

To put this trend in context, it's useful to include an historical perspective. Russell Investments began managing multi-asset mandates — with discretion — in 1980. At that time, one of Russell's consulting clients requested a fully diversified investment solution for a middle-market subsidiary whose investments had to be managed separately.

In response, Russell began providing a fully implemented investment solution, complete with sophisticated portfolio strategies similar to those recommended by Russell's

¹ Casey Quirk notes that the outsourcing assignment may be less than 100%, in which case: “Another way to further define and understand investments outsourcing ... involves comparing it to a traditional investment consultant-investor relationship. Investments outsourcing is distinctly different in a number of ways, including greater levels of discretion, asset- and performance-based compensation arrangements, and a wider use of proprietary vehicles, including many focused on alternative investments.”

² “Investment Outsourcing Research Update,” Casey Quirk & Associates, December 2009.

consulting group. Today, the descendants of these early groundbreaking vehicles typically include strategic advice and implementation with discretion that ranges from simply hiring and firing managers to full investment responsibility that encompasses asset allocation as well. Because of the variety — and complexity — of these relationships, many use the term "enhanced fiduciary solutions," as it is a more accurate description than "investment outsourcing." In the U.S. and Canada, Russell currently provides this type of outsourcing solution to nearly 300 institutional clients representing over \$43 billion in assets. Non profit organizations can leverage these insights to set realistic expectations, and consider investment outsourcing as an option especially when financial constraints prevent them from adding resources internally.

IT'S NOT ABOUT "GATEKEEPING." TODAY'S NON-PROFIT INVESTORS ARE SEEKING TO IMPROVE THEIR PERFORMANCE AS FIDUCIARIES

In any discussion of investment outsourcing, it helps to stay focused on the non-profit investor's objectives. During the extended bull-run from 1982 through 1999, investors profited from the secular upward trend by seeking top-performing managers, alternative strategies, and hiring consultants to identify them. As absolute returns remained strong, many non profit investors seemed content to work with consultants for their investment manager decisions. While the investors didn't necessarily see their consultants as "gatekeepers," they effectively acted in that capacity towards the investment managers.

Today, the consequences of poor performance are potentially lethal. An underperforming endowment or foundation places an economic burden on the organization's core mission and its beneficiaries. We saw extreme cases of this following the 2008-09 financial crisis. For example³, Yale University cut staff and non-salary expenses by 7.5% for the 2010-11 academic year while Harvard University had to lay off staff, suspend faculty searches and delay its campus expansion plans.

In this environment, non-profit organizations are turning to providers who understand the challenges they face and who can help them with their fiduciary duties in the broadest sense. Desirable capabilities include: *professional expertise in risk management, effective implementation and good governance*. While an outsourcing provider may still look like a gatekeeper to investment managers, the non-profit organization's perspective is really to *insource* a provider to help shoulder the burden of fiduciary responsibility.

In this context, Casey Quirk's definition of outsourcing is merely functional; it describes the method, but not the purpose. Properly understood, an institutional investor that is outsourcing or "delegating a majority of its assets" is actually choosing a provider that has a larger and more experienced resource pool as a way to manage investment risk and align their investment strategy with desired liquidity, cash flows and spending levels. The extension of "investment discretion" is what allows the outsourcing provider to react effectively in fast-moving markets.

By providing a turnkey approach to implementation, the outsourcing provider stays focused on the key issues, such as providing meaningful advice, developing strategies for asset allocation, structuring the portfolio, selecting and monitoring investment managers, rebalancing, staying current with regulatory requirements and coordinating the operations of multiple parties involved in the investment program. Because the outsourcing provider is focused on these issues, the non-profit staff and board are free to focus on their mission critical issues such as donor relationships and school operations.

³ Wall Street Journal - Financial News: Harvard, Yale are big losers in 'The Game' of Investing, 11 Sep 2009

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ENDOWMENTS AND FOUNDATIONS CAN LEVERAGE THE PROFESSIONAL EXPERTISE OF THE OUTSOURCING PROVIDER

Russell Investments' founder, George Russell, helped "invent" the pension consulting business when he performed the first manager search for JCPenney in 1969 and for the first Russell foundation client a few years later. After that, the professionalization of the internal investment oversight function, and investment management responsibility developed quickly. As George Russell notes in his recently published memoir, *Success by Ten*:

In 1969, only the treasurer was paying attention to the pension plan. Now these corporations all have major teams of highly sophisticated investment professionals. Our clients' increasing ability to perform more of the work themselves changed the dynamic of our relationship. We knew Russell had to develop new capabilities that were of value for them or we'd never have a job.

Enumerating those "new capabilities" provides a fairly accurate summary of the scope of work that is required in a modern investment management program. If the non-profit organization doesn't have the expertise to manage these functions in-house, then the following list is a basic job description for an investment outsourcing provider:

By managing risk on the portfolio level, the outsourcing firm frees the individual manager to focus on return potential rather than diversification.

- 1. Strategic planning and oversight.** Your outsourcing provider will need the skill and tools to analyze your specific asset allocation/spending challenges, articulate an investment strategy and implement a program that will allow you to achieve your goals at an acceptable level of risk while satisfying your obligations, managing costs and minimizing volatility of key financial metrics. This requires personnel who are well versed in compliance, asset/spending modeling, regulatory environment, administrative details and the tracking and monitoring of fund performance against objectives.
- 2. Traditional and alternative investment strategies.** Today's environment dictates that non-profit organizations focus on liquidity and spending goals as well as total return. Endowments and Foundations seeking higher returns need to consider alternative assets and portfolio engineering techniques. Incorporating alternatives along with traditional asset classes requires sophisticated approaches to asset allocation, so it's important to work with professionals who have the required expertise in all of these areas.
- 3. End-to-end implementation.** It's clear that the transition from a consultant recommending managers to a full-service outsourcing provider involves an extended learning curve. It requires significant adjustments to credibly assume the level of liability that comes with fiduciary responsibility. Implementation of a complex, well-diversified portfolio is a task requiring significant resources. Oversight must be continuous: Each manager needs to maintain its style discipline in order for the total portfolio to maintain its designated level of residual risk. Building and maintaining a diversified and effective investment program involves important day-to-day decisions. Portfolios must be tracked, managers monitored, administrative details managed and regulatory changes evaluated and implemented. If manager replacements are needed, they must be implemented in a timely fashion. Transition management should be carried out cost-effectively. Cash drag should be minimized using stock index futures. And a rebalancing policy needs to be developed and maintained.
- 4. Value-added administrative services.** Staying on top of the operational details is crucial, but often time and resource intensive. Administrative efficiency and effectiveness is a key benefit for non-profit organizations considering a full-service outsourcing arrangement. The ability to delegate to a single provider a variety of

responsibilities — trustee and custodial services, donor recordkeeping planned giving administration, donor advised services, endowment accounting, distribution services and audit assistance — is a significant source of added value in the management of your investment program.

Professional competence is the key in all four areas: strategic planning and oversight, investment strategies, implementation and administrative services. An outsourcing provider needs to have a deep bench with experience in every position.

AN EFFECTIVE FIDUCIARY PROVIDER SHOULD INCREASE ACCESS TO MANAGERS — ON THE NON-PROFIT ORGANIZATION'S TERMS

When choosing an investment outsourcing provider, it's important to consider three factors:

- The range of investment options available
- The degree of objectivity and ability to provide qualitative, forward-looking insight
- The ability to provide the advantage of scale

First, today's investment managers are specialized as never before. A fully diversified portfolio may include equities, fixed income, real estate and alternative assets, with each asset class subdivided by geographic region, capitalization, style, sub-style and the various types of alternative assets (hedge funds, private equity, infrastructure, commodities). The wide range of investment choices provides unprecedented opportunities, but also means that considerable experience is required to manage them.

A provider of investment outsourcing needs to have considerable resources dedicated to researching and evaluating the managers available in each category. In addition, sophisticated analytics and years of hands-on experience are required to construct and manage a well-diversified portfolio that manages risk and performs well in a variety of market environments.

Second, in its role as the fiduciary responsible for manager selection, the provider must recommend the investments that best meet the needs of the client. The investment outsourcing provider must demonstrate how it manages potential conflicts of interest, such as the willingness to use non-proprietary products or to recommend asset mixes that may generate lower fees.

The need for objectivity extends to the provider's manager selection criteria. This is a difficult undertaking; on the one hand, quantitative criteria are not adequate to assess a firm's ability to perform well in the future. Data reflects past performance only and as such is an unreliable predictor of future results. To be effective, a manager evaluation process must include qualitative assessments of each firm's professional staff, along with its management and incentive structure, investment process and the resources available to support that process. This process requires personal knowledge based on face-to-face interviews. Yet the outsourcing firm must take care to remain at arm's length with the managers it recommends. In effect, the investment outsourcing provider must demonstrate that it has an effective sell discipline in place.

In addition to its range of assets and objective scrutiny, the third important element for an investment outsourcing firm is its ability to provide scale on behalf of its clients. This is a case where bigger *is* better. As an aggregator of assets, the solutions firm can be an extremely attractive client for top-tier managers. Tangible results can include access to products that might be closed to new investors; the ability to work with a manager to customize a product for its clients' special needs; and, of course, receiving the most favorable fee structure that the manager has available.

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GOOD GOVERNANCE MEANS RUNNING YOUR INVESTMENT PROGRAM LIKE A BUSINESS

A simple working definition of good governance is the establishment of a structure where every decision will be made by the people who are in the best position to do so. For endowments and foundations, good governance exists when the board members are allowed to focus on issues that impact the long-term mission of the program and its impact on the success of the organization, rather than being responsible for investment decisions.

At the other end of the spectrum, security selection decisions should be made by investment managers who have very specialized expertise in their particular area. In between those two layers resides the outsourcing provider, who is in charge of making sure the staff and board members' orders are executed as effectively as possible.

By managing risk at the portfolio level, the outsourcing firm frees the individual manager to focus on return potential rather than diversification. A well-governed investment program functions like a well-run business. In their regular meetings, board members should note whether the volatility of cash flow is within expected ranges, costs are under control, spending policies are reasonable, and the program is on track to fulfill its obligations.

Keep asking questions

Ideally, this discussion will inspire endowments and foundations to think of their investment programs in new ways. It is always tempting to define success in terms of investment performance, or alpha; but that would be mistaking the means for the end. Of course the "end" depends on each fund's particular situation. That is why it is so important for non-profit organizations to keep asking questions when considering working with an investment outsourcing provider: This is a close, comprehensive and long-term relationship, so it's critical to get the right relationship.

About Russell Investments

Founded in 1936, Russell Investments is a global financial services firm that serves institutional investors, financial advisers and individuals in more than 40 countries.

Through a unique combination of interlinked businesses, Russell delivers financial products, services and advice. A pioneer, Russell began its strategic pension fund consulting business in 1969 and today is trusted by many well-known worldwide institutions for investment advice. Headquartered in Seattle, Washington, USA and with offices in major financial centers worldwide, Russell has \$149 billion in assets under management (as of 9/30/10) in its mutual funds, retirement products, and institutional funds, and is well recognized for its depth of research and quality of manager selection.

Russell offers a comprehensive range of implementation services that helps institutional clients maximize their assets. The Russell Indexes calculate over 50,000 benchmarks daily covering 65 countries and more than 10,000 securities.

For more information:

Call Russell at **800-426-8506** or e-mail jgelly@russell.com
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