NORTHERN TRUST

DIVERSIFYING OCIO PROVIDERS

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Harry Markowitz – the venerable economist and Nobel Laureate – coined the phrase "diversification is the only free lunch in finance." As evidenced by our asset allocation and portfolio construction approach, we agree with this adage. However, in a well-intended attempt to cash in on this free lunch, we regularly see investment committees misapply the diversification principle when choosing an outsourced investment advisor. In a search for diversification, organizations occasionally choose to split their assets across more than one provider, which can unfortunately lead to higher costs, suboptimal portfolios and inefficient reporting as will be shown in this paper.

This piece highlights the potential drawbacks of using multiple providers for outsourced investment management services.

HIGHER COSTS

Most advisory firms charge fees based on the total market value of the relationship. Economies of scale allow firms to provide lower pricing as the market value increases.

Consider the following fee schedule and subsequent example. The fees and breakpoints in the table are being used for illustrative purposes only. However, it is common for firms to charge fees using a sliding fee schedule.

	Asset Value (milions)	% of Asset Value
First	10	0.60%
Next	15	0.30%
Next	25	0.25%
Next	50	0.15%
Next	100	0.10%

Organization A: Has $75 million in assets split among three (3) OCIO providers, with $25 million at each provider. Based on the fee schedule, each firm charges 60 basis points on the first $10 million and 30 basis points for the next $15 million. **This results in a total fee of $315,000.**

Organization B: Also has $75 million in assets, but uses only one investment provider who charges 60 basis points on the first $10 million, 30 basis points for the next $15 million, 25 basis points for the next $25 million and 15 basis points for the final $25 million. **This results in a total fee of $205,000.**

Despite having the same fee schedule and the same amount of investable assets, Organization A pays $110,000 (54%) more in fees by splitting their assets and not fully taking advantage of the fee breakpoints.

SUB-OPTIMAL PORTFOLIO DESIGN

We believe the main drivers of most excess returns in a portfolio come from two important decisions: 1.) Asset Class weightings and 2.) Manager Selection. Given the critical nature of these decisions, a proven process for asset allocation and manager selection are the hallmarks of strong OCIO providers. However, these strengths can quickly erode when utilizing multiple advisors. Consider the example below:

Advisor 1
In seeking to manage portfolio risk given the recent runup, the advisor tactically underweights Emerging Markets by 2% to the policy benchmark.

Advisor 2
In order to build on the recent strength in Emerging Markets, the advisor increases the allocation by 2% to the policy benchmark.

While simplistic in nature, this example results in a neutral portfolio allocation and the decisions of both advisors cancelling one another out. Not only can these decisions occur at the asset class level, we consistently see this neutralizing phenomenon with manager styles (value/growth) as well as factors (duration, credit, market cap). Ultimately, this advisor dilution results in sub-optimal portfolio construction and the potential for suboptimal performance returns.

As it relates to portfolio construction and fulfillment, minimum investment requirements on certain solutions can curtail the investment managers ability to use all of the investment options available to them. Generally speaking, managers require a certain minimum investment to gain access to lower priced investment solutions as well as to some alternative investment options. By combining assets with single investment provider, it is more likely that solutions such as hedge and private equity can be added to the portfolio.

An Outsourced Chief Investment Officer serves as an extension of an organization's staff and can help reduce administrative burdens, but having multiple OCIO managers may actually diminish this benefit.

Reporting consolidation. A major reason for using an OCIO to serve as an extension of an organization's staff is to reduce the inherent administrative burdens. However, using multiple OCIO managers may actually diminish this benefit. In order to create a holistic view of the entire portfolio, staff would be required to consolidate reporting for both accounting and performance purposes across all OCIO managers as well as the individual investments that they own. These additional steps increase the work for staff and layer on unnecessary expenses and complexity for the organization. These include increased staffing needs, additional reporting systems and the potential for errors. Taken together, these drawbacks oftentimes outweigh the benefits of using multiple advisors.

There are, however, certain instances where using two separate OCIO's can be employed without compromising portfolio design or reporting needs. We most often see this when bifurcating the marketable securities from private investment vehicles. In this scenario, each OCIO has special expertise which allows them to add value in their individual "silos" of the portfolio. Given the distinct differences of private vehicles, there is little opportunity for advisor "dilution" mentioned above. This exception to the rule usually applies to very large organizations that have a significant allocation to private assets.

In summary, while not "putting all of your eggs in one basket" can certainly sound appealing when selecting investment advisors we have found we believe that the path to success is best met through the use of a single, well-resourced OCIO. This model provides the greatest opportunity for cost effectiveness, well-managed portfolio allocations and seamless reporting consistent with an overall plan.

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