The Rise of Global OCIO Services and the Implications

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Institutional investors in the US and Europe tend to outsource investment management to external managers, i.e., outsourced chief investment officers (OCIOs) on a full or partial discretionary basis. Growth in the global OCIO market stems from the move of institutional investors seeking more efficient asset management amid the low interest rate and low investment returns. OCIO services' expansion in the post-crisis era implies that asset management companies are jumping in value-added, comprehensive investment management services. Although some Korean public funds adopt the "lead manager system" akin to OCIOs, it is highly likely for private pensions to become a core client pool in the OCIO market going forward. Korean asset management companies seeking to create value by playing a key role in domestic and overseas OCIO markets should build their capabilities as an OCIO. Toward that end, they are required to carry out bold investments in necessary areas such as human resources.

The rise of the outsourced chief investment officers (OCIO) model is one of the dominant trends in the global asset management market. An OCIO refers to an external service provider who is hired to provide full or partial discretionary investment management services for large-scale investors such as institutional investors or high-net-worth individuals. Such services are mostly provided by asset management companies, professional investment consultants, and pension actuaries, etc. Their major work scope differs depending on the services delegated, but includes almost all tasks related to investment management. In most cases, OCIO providers

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carry out tactical asset allocation, hire external investment managers, internally manage the outsourced assets, and measure performance. But they are at times directly or indirectly involved in more important tasks, e.g., asset-liability management, strategic asset allocation, and the investment policy statement (IPS).

A similar business model has just started in Korea. Since the investment pool for public funds by the Ministry of Strategy and Finance adopted the "lead manager system" akin to OCIO services in 2001, this has expanded to other funds such as the Housing and Urban Development Fund by the Ministry of Land, Infrastructure and Transportation; the Employment Insurance Fund and Workers' Compensation Insurance by the Ministry of Employment and Labor; and the investment pool for private pension funds by Korea Securities Finance Corp. (KSFC). But the lack of experience and service diversity of service providers and excessively low fees make OCIO services hardly viable as a revenue model.[1)] This article touches upon the current state of the global OCIO market, the background behind the market's growth, and the implications of such growth for asset management companies. Then, I look at Korea's OCIO market to assess the potential and to discuss future directions in which Korean asset managers should head for enhancing their role as an OCIO.

Current state of the global OCIO market

According to the data from Pension & Investments (P&I, 2015), the aggregate amount of assets managed worldwide for institutional investors amounted to approximately $1.4 trillion (KRW 1,550 trillion) as of March 2015, a 16% increase from the same period of the previous year.[2)] Russell Investments, an investment consulting firm, was the largest OCIO provider with $117.3 billion in outsourced assets under management. Among the top 10 OCIO providers, there were six asset management companies and four investment consulting firms including Russell Investments. Investment consulting firms that have proliferated since the enactment of the Employee Retirement Income Security Act governing the US corporate pension system are known to recruit a wide variety of corporate pension experts including investment managers. Banks, trust companies, and investment banks also provide OCIO services.

1) Refer to Public Funds' Lead Manager System: Meaning and Implications (Chaewoo Nam, 2015, KCMI Capital Market Opinion).

2) Refer to the Special Report: Investment Outsourcing (P&I, 2015).

A survey released by investment data provider Asset International (AI, 2016) shows a more detailed picture on who clients and service providers are in the OCIO market.[3] Differentiated from P&I statistics, AI data include full discretion services only. As of the end of 2015, corporate pensions were the largest client pool managing 52.4% of outsourced assets in aggregate. Endowments/foundations and public/government pensions accounted for the second largest proportion. Also, insurance companies were one of OCIO clients although the size was not large.

A regional breakdown on the client data that were available from seven players out of top 10 OCIO providers showed that clients from the US and Canada accounted for 73.1% and those from the UK and Europe for 16.1%. Clients from other regions represented a negligible percentage. Notably, almost 69% of the clients surveyed was found to have outsourced investment management functions for over three years. Give that quite a few of those have used outsourcing for over a decade, the contract period between OCIO clients and service providers seems not short.

When it comes to the fees OCIO providers receive in exchange for their services, a total of 58% of contracts were based on flat fees while performance fees were adopted in only 20% of contracts. But contracts based on performance fees have been on the rise every year. Although the exact fee level charged by OCIO providers is unknown, the average fee is estimated to range from 30bp to 100bp depending on the size of outsourced assets.[4]

Behind the growth of the OCIO market

The 2016 survey by AI also questioned institutional investors (clients) the reasons for outsourcing investment management. Respondents were given seven reasons and asked to rank them in order of importance. The followings list the result in descending order according to the proportion of respondents citing each of the item as the most critical: Lack of internal resources (56%); additional fiduciary oversight, better risk management (38%, each); need to increase returns, faster implementation/decisions (31%, each); desire for strategic partnership (18%); and cost savings (11%). Such results indicate that investment returns are not necessarily the only factor explaining institutional investors' tendency of outsourcing. Despite the importance of converging various tasks (e.g., transparent supervision, faster decision making, and a balance

3) Refer to the 2016 Outsourced Chief Investment Officers Survey (AI, 2016).

4) Refer to Considering the OCIO Option: Not an Everyday Decision for Fiduciaries (RV Kuhns & Associates, Inc., 2013).

between returns and risk management) for managing ever-growing assets properly, institutional investors came to realize that they lack internal resources for carrying out all of those tasks.

Taking into account that view, the rapid expansion of the global OCIO market seems attributable to the following three aspects. First, it is extremely difficult for institutional investors to rely entirely on internal resources to boost their asset values amid the prolonged low-interest-rate and low-return environment. Second, the growing diversity in financial products and distributors is adding difficulties for institutional investors to choose suitable products and distributors. Third, what is critical under today's complex financial market environment is the duty of fiduciary oversight that can be enhanced only by external experts such as OCIO providers.

To sum up, the global OCIO market grew behind the firm belief among institutional investors that OCIOs contribute to stronger asset management governance and consequently enhance efficiency in asset management.

Implications of OCIO growth for asset managers

In the past, asset managers were expected to focus on selecting the most optimal investment assets at which they have strength. Comprehensive, customized asset management services such as strategic asset allocation and asset-liability management were regarded outside their boundary. Rather, asset managers were asked to play a limited role of simply providing fund products or discretionary investment services based on decisions made at the upper level by asset owners.

But more recently, not only institutional investors and high-net-worth individuals, but also retail investors are keen to go beyond mass products and choose so-called "investment solutions" reflecting their own investment purposes. Target date funds, asset allocation funds, and absolute return funds are some of the examples although they are not a perfectly customized product. Domestic and overseas asset management companies have already designed and provided partially customized products to the public.

On top of that, the rapid expansion of the global OCIO market and the increased role played by asset management companies imply that asset managers have already jumped in comprehensive investment management services in full throttle. It is noteworthy that the global OCIO market has been widely recognized as a new, high value-added business, which inevitably creates severe competition.

Potential in Korea's OCIO market and challenges ahead

The background that fueled the growth of the global OCIO market can be applicable to Korea. Unlike developed countries already in the decumulation phase, Korea's pension assets can be accumulated for a substantially long period going forward. In particular, the size of retirement pension assets is projected to increase steeply. The introduction of trust-based retirement pensions will see a greater number of retirement pensions achieving economies of scale, e.g., single-employer pensions by large-sized companies. Accordingly, many private pensions will emerge as a formidable client base in Korea's OCIO market where public pension funds are currently dominant clients. The case of developed countries demonstrates that university endowments and foundations can be prospective clients in this market. Of course, small-scale private pension funds can tap into OCIO services via KSFC's investment pool for private pension funds. However, there will be clear demand for enjoying superb services from individual OCIOs.

The Korean OCIO market emerged based on public funds as a dominant client pool, but is currently viewed as a hardly viable revenue model due to the limited service scope and excessively low fees. If OCIO providers build up their capabilities to serve for a number of retirement pensions or other private pensions, this may help reevaluate, albeit limitedly, the optimal fee levels. Because of the low-profit structure of Korean OCIO services, Korean asset management companies may seek to expand overseas if they vamp up the efforts for improving their OCIO capabilities.

What is vital is how Korean asset management companies can build their capabilities for OCIO services. First and foremost, they need a system through which they can fully understand and carry out comprehensive OCIO services. For example, pension funds with a long-term liability must carry out strategic asset allocation fully considering the optimal funding level, a service currently out of the range of Korean asset management companies. Although this is a task mostly implemented by a top decision-making body (an operation committee or a board) in overseas cases, it is known that OCIO providers often intervene in the process via advisory services, etc. For this, OCIO providers must aggressively recruit professionals needed to assess the payout structure for pension beneficiaries as well as the optimal funding level. The importance of manpower will grow further as the number of clients receiving OCIO services rises. Because every institutional investor differs in nature, OCIOs must fully understand the unique nature and reflect that in designing customized services.

Also important is a due diligence system in selecting external managers. In Korea, there are over 100 asset management companies authorized by law. If overseas players are included, the due diligence process will get much more complex. Hence, it would be critical to build a database that includes not only the list of domestic and overseas service providers, but also the data on their service features. Another area requiring attention is a tool that systematically compiling data on the whole OCIO service process including risk management, performance evaluation, reporting, etc.

In conclusion, capabilities of OCIOs are determined by their ability to provide customized services suiting individual needs of a wide range of customers. And this requires aggressive investments in manpower as well as systems. Going forward, asset management companies seeking to advance into OCIO services in search for a new revenue model must make bold decisions based on their market insight.