A Thought on Korea's Growing OCIO Market

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Korea's OCIO market usually led by large-scale public pension funds has recently seen a continuous inflow of funds in different nature, for example, private sector firms and university endowments, etc. Another growth driver in the market could be institutional-type retirement pension funds as a relevant bill was recently proposed. However, Korea's current OCIO model has some distortions that could be a drag on market growth. Compared to overseas cases, the range of delegated tasks and management discretion are excessively limited in Korea's OCIO market.

Potential clients in the OCIO market should be any asset owner who tries to manage large funds with limited expertise and internal resources. What's necessary for helping that potential demand to enter the market successfully is to build a target-oriented OCIO structure that suits the needs of diverse funds. Korea's current practice of dedicated management not only dilutes the benefits of the OCIO model, but also hinders the entry of smaller funds such as retirement pension funds. The OCIO model's unique competitiveness lies in its flexibility that serves both pooled investment for economies of scale and customized investment for individual clients.

Introduction

An outsourced chief investment officer (OCIO) refers to a practice that outsources overall investment management including strategic decision makings to a third party.[1)] Recently, Korea's OCIO market has been on the rise. There has been an increase in asset owners seeking

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1) This refers to a strategic discretionary investment management service where an asset owner delegates all or part of its investments to a third party fiduciary.

to shift away from conventional outsourcing to an OCIO model, which accordingly led to a visible improvement in capability of OCIO service providers.[2] This is viewed quite positive from the perspective of building a sound market ecosystem. Going forward, the introduction of institutional type governance is expected to further grow Korea's retirement pensions market that is already over KRW 200 trillion.

However, some distortions in Korea's OCIO market could cast some doubt on that positive projection. According to a case study on selective global OCIO service providers,[3] Korea's OCIO market—despite its two decades history—is structured quite differently from overseas markets in terms of the roles and responsibilities, economies of the scale from pooling, fee structures, and others. Such differences could have stemmed from one factor: Unlike overseas OCIO providers that grew their business based on a strategic, individualized total solution for multiple corporate clients, Korean players have played a narrow range of limited roles as a third-party carrying out execution function for a large-scale fund. A survey by Chief Investment Officer (2019) revealed that the biggest reason using an OCIO is limited internal capacity for managing assets strategically in a complex market environment. Such client demand could be hardly addressed by Korea's current OCIO structure that lacks a strategic and holistic approach.

Korea's near KRW 100 trillion OCIO market is likened to an oligopoly: More than 80% of assets under management are concentrated in five largest public pension funds[4] that are managed by five OCIO service providers.[5] The market structure hinders the market principle that is supposed to enable firms to freely compete to enter and exit the market. The oligopolistic structure is the culprit of many issues, say, the unreasonably low fee scheme, the seemingly unfair competition in OCIO selection that occurs as infrequently as once or twice per year, etc. What matters the most under the circumstances is to eliminate the current institutional shortcomings, which will allow more asset owners with different size and asset profiles to opt for an OCIO for managing their assets.

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2) In overseas markets, consulting companies such as Russell investments and Mercer are major providers in the OCIO market, whereas Korea's market centers around securities firms and asset management companies.

3) Focus interviews with three out of the five largest OCIOs in terms of assets under management were conducted. For details, please refer to Challenges Ahead of Korea's OCIO Model (KCMI Issue Paper 19-05).

4) National Housing Fund, Workers' Compensation Insurance Fund, Employment Insurance Fund, Korea's investment pool for public funds / private funds

5) Mirae Asset Global Investments, Samsung Asset Management, Korea Investment Management, NH Investment & Securities, Korea Investment & Securities

Potential clients for OCIOs could include a diverse pool of asset owners seeking to manage large funds with limited internal human resources lacking expertise, for example, not only retirement pensions, but also public pension funds, mutual aid associations, and other firms that have accumulated more retained earnings, etc. There are many institutional improvements to make, not to mention drastic changes in perception among market participants, for helping the market to serve for that potential demand. However, the most imminent and critical challenge could be summed up to two elements: A target-oriented OCIO model, and a shift away from a dedicated structure. All funds seeking to search OCIOs vary in asset size and purpose. Each fund's individualized nature requires target-oriented OCIOs, whereas the dedicated management structure could be inefficient, hindering the entry of small and medium-sized funds.

Importance of target-oriented OCIOs

Compared to conventional investment outsourcing,[6] the OCIO model is differentiated in terms of its holistic approach, which refers to not only the diversity of asset classes that make up a diversified portfolio, but also the whole process of investment decision makings associated with investment management. An OCIO model entrusts a more holistic range of tasks as compared to conventional investment outsourcing, which gives an OCIO wider discretion. As its title implies, outsourcing the chief investment officer job—not the fund manager job—to a third party means to entrust a series of higher-level, strategic decision makings including investment execution. In other words, an OCIO that is not delegated the task of strategic decision makings could hardly achieve the model's intended outcomes of addressing the problem of conventional investment outsourcing.

The OCIO model has a highly flexible structure in its management style and investment assets. According to a contract established between a fiduciary and an asset owner, all or part of investment assets could be entrusted. Although the model targets all kinds of financial assets, it's also possible to entrust specific types of assets such as alternative investments or overseas investments. Also diverse is the type of tasks to be delegated to an OCIO. Any of those cases, however, involves a substantial part of strategic decision makings, which requires OCIOs

6) This refers to beneficiary certificates taking the form of privately placed funds, and an outsourced investment management such as discretionary investment management.

to have sufficient management discretion. For example, If a single asset class is cut into parts and entrusted to several OCIOs who are required to manage the same asset with the same investment strategy, the responsibility of making strategic management decisions for each part of assets will fall fully upon the shoulders of each OCIO. Such an OCIO model has the same effect of a fund of funds. An OCIO should be able to present a differentiated goal and management structure differentiated from the conventional one, which could make more costly OCIOs be regarded as a viable option.

A good starting point for target-oriented OCIOs is the request for proposal that is submitted by an asset owner in the search for an OCIO. Whether it's a public fund or a private firm, all assets have varying objectives and management goals. Any asset owner seeking to adopt the OCIO model first needs to spend time and effort on drafting an RFP that fully reflects the management method and goal of the fund to be managed. Desirably, an RFP should include clear descriptions on the goal of investment management and the role of the OCIO. Also necessary is the selection and evaluation criteria, fee levels, and how to manage a selected OCIO, etc., which could help asset owners to achieve their goal. For example, funds with the same mid-to long-term horizon could require completely different investment strategies: Although both idle money in project funds and buffer funds for defined liabilities are mid-to long-term assets, the two require completely different investment strategies that also need different roles and capabilities of OCIOs.

Once a preferred negotiator is selected based on the aforementioned RFP, an investment policy statement (IPS) should be drafted during technical negotiations. An IPS functions as a key management instruction when an OCIO manages an asset owner's assets in line with what's proposed in the RFP. Most public sector funds working with OCIOs apply their internal IPS to OCIOs as well. However, an IPS established to serve the overall fund's purpose should be different from an IPS for outsourced investment management that covers all or part of the fund. A fiduciary—in other words, an OCIO provider—uses their internal management guideline as an IPS, which fails to reflect the factors specific to each asset owner. It's important to forge a target-oriented relationship between an asset owner and a fiduciary and to clearly document it. This could not only minimize the agent problem inherent in the OCIO model and prevent potential conflicts of interest, but also effectively align the interest of an asset owner and a fiduciary for the whole investment period.

Inefficiency in dedicated management

Currently, most OCIOs in Korea have a dedicated management structure which refers to an independent, physically separated investment management team and the system. In other words, the team that carries out the whole investment management cycle (plan-do-see) stays in a physically separated space and is excluded from all other tasks except for managing the entrusted asset. Furthermore, essential systems such as a risk management system should be physically separated from the mother company. However, such a dedicated structure hardly fits the initial motive behind the OCIO model which aims to address the lack of internal resources by outsourcing.

First, a dedicated structure could be ineffective in terms of costs. An asset owner seeking to find an OCIO might have assumed that outsourcing would be more cost-effective than establishing the same human and other resources within its organization. However, a dedicated structure sets up the same internal division outside the organization, which incurs the exactly same costs as those arising from establishing an internal team. Systematic investment management usually requires certain minimum workforce and systems, regardless of asset size. Even a small fund holding less than KRW 1 trillion requires one business unit with four teams, each of which should be equipped with a standalone office space and IT systems. This alone incurs the annual operating costs of at least KRW 1.5 billion. When the fee is below 3bp, the annual operating costs of KRW 1.5 billion could be affordable only for those managing at least KRW 5 trillion. Even when institutional-type retirement pensions are introduced, it's hardly likely for a single fund's assets under management to go over KRW 5 trillion. This means only large-scale players can access to OCIOs that were originally purposed to benefit small to medium-sized funds. Such a paradox primarily stems from the industry's demand for a dedicated structure.

Another point worth mentioning is external expertise. Allocating a dedicated team could be an institutional guarantee for an OCIO's promise to provide quality service continuously. However, expertise in investment management cannot be guaranteed by the number of managers. Also, in selecting an OCIO, asset owners tend to consider an OCIO's overall staff competition as the measure of management expertise and capabilities, which is somewhat unfit for dedicated structure. It's hardly likely for an OCIO provider to let an outperforming manager work at a team whose service is dedicated for a single client. Under outsourced investment management, it's a fiduciary's duty to provide quality service, which can be guaranteed only by a reasonable performance evaluation system.

An independent management system as part of a dedicated structure aims to prevent leaks of any client-related sensitive information. However, the Chinese wall could also be a stumbling block when an OCIO provider tries to mobilize its entrepreneurial network and costly IT infrastructure. Such an information constraint could have a more direct impact than expected on alternative or overseas investments that have recently come to the forefront. It's important to note that keeping client information secure is the most fundamental duty for a fiduciary managing assets on behalf of its client.

Another critical issue with regard to dedicated structure is the negative perception on pooled investment management. Korea's OCIOs have been taking a segregated approach, running independent managers and funds for all asset classes such as bonds, stocks, alternative investments, etc. This is also the case for Korea's investment pool for public funds that was established to achieve economies of scale by the Ministry of Strategy and Finance. Once a fund grows and its assets under investment reach a certain level, a segregated investment is preferred to a pooled investment. However, a segregated investment provided by the investment pool for public funds is no different in an economic sense from a standalone privately placed funds regulated by financial authorities. Economies of scale achieved by pooled investment management is a competitive edge of the OCIO model.

From that perspective, it's meaningful to see Korea's investment pool for public funds have recently been pushing for outsourcing the management of small-sized funds on a full discretionary basis, which perfectly fits the OCIO model in a real sense. Those small-sized funds will delegate OCIOs the whole process of investment management—from building a portfolio to performance evaluation, risk management, and investment management—on a full discretionary basis. This is a totally new path that has never been treaded by any Korean OCIO provider. Although an OCIO provider pools funds from several asset owners, it should make every asset owner feel as if being individually served. Going forward, OCIO services for multiple retirement pension funds are expected to take the similar structure. It's useful to benchmark the case of All Pension Group (APG), a Dutch investment management company for public pension funds.[7] APG is known to run a quite large customer service unit for serving a large number of public pension funds in different nature as an OCIO.

7) First established for managing the Dutch fund ABP in 2008, it is now an OCIO for key public sector institutions such as the national health insurance fund.

Conclusion

Korea's OCIO market is expected to grow fast both in terms of supply and demand. The OCIO model is widely viewed as an effective alternative to delegating the whole management process among many asset owners in Korea that seem to lack in governing function relative to their assets under management. Asset management firms, a fiduciary, have been mobilizing firm-wide effort amid expectations that institutional-type retirement pensions could grow Korea's OCIO market significantly. Despite the solid supply and demand bases, Korea's OCIO market currently fails to satisfy the market participants due to its structural inefficiency.

It's the asset owner who has to play the leading role of changing the unreasonable market structure. Equally important at this juncture, however, is to bolster the fiduciary's investment management capabilities first given that the market will see an active fund inflow from not only private sector firms but also institutional-type retirement pension funds and other small- to mid-sized funds. In Korea's OCIO model, strategic decision makings have thus far fallen under the hands of asset owners who lack expertise, with OCIOs playing a limited role of consultation. However, OCIOs are expected to have a stronger role and responsibility going forward. And it's worth underscoring that the competitiveness of OCIOs lies in a broad range of delegated tasks that encompass several clients and the whole investment management process.