



# Does Outsourcing the Investment Office Make Sense?

*A Firsthand Perspective by a Former – Now External – CIO*

*Spring 2010*

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In today's world, a multitude of options is available for endowments and foundations to manage their assets. But which is best for your organization? This commentary focuses on how I, as a Chief Investment Officer, grappled with this question, and how I came to recommend that my own function be outsourced.

Why would I tell my employer to hand my own job to an outside provider – giving up a position that afforded me virtual autonomy as an investment professional? I saw it as a way for my institution to get needed additional resources in managing its assets – more research staff, better administrative support (especially critical in a time of ever-increasing auditing demands), and more investment professionals to work on the institutional portfolio. But, as I concluded my investigation, I found that an even more compelling case for the external CIO option lies in its cost efficiency. Here, I concluded, was a way for institutional investors to cut the Gordian Knot tying depth of resources to higher costs. With this option, more infrastructure need not require more expenditure.

Resources always seem scarce in the not-for-profit world, but the situation worsened in 2008. Institutions watched their investment portfolios plummet by 24% on average<sup>1</sup> during the last half of 2008, which put pressure on resources like never before. Not-for-profits announced spending reductions across the nation, including postponed building projects, hiring freezes, suspended salary increases and monitoring thermostats in buildings. If there is a positive among all of this carnage, the last step is helpful to the environment.

Unfortunately, that may be where the positives stop. Most likely, the investment staff and perhaps even the investment committees are being questioned as to their thinking in creating an investment portfolio that could decline so much so quickly. Before we get too carried away looking for someone to blame, let's remember that the savviest investors among us fully participated in the market slide. Harvard and Yale, long considered to be uppermost among endowment investors, each were projecting losses of approximately 30% of their assets in the last fiscal year — nearly \$18 billion, said the Wall Street Journal.

Who would have guessed that the great investment banks, and even our big commercial banks, which often were touted for their risk measurement systems, seemed to have had no idea of the downside potential of their portfolios? Even Alan Greenspan, the venerable former Federal Reserve Chairman, expressed surprise that the banking industry had not done a better job policing its risk. Even now it seems inconceivable that these renowned institutions were so negligent in applying basic steps in risk mitigation, such as reducing leverage.

The experiences of 2008 have underscored some basic principles that people frequently forget in the midst of bull markets – due diligence matters, liquidity matters, and careful

<sup>1</sup> CommonFund Institute & NACUBO Study of 235 institutions from 7-1-08 through 12-31-08

construction of a portfolio matters.

The press is full of accounts of how “hard hit” the large endowments were in the downturn, and recent reports have played up the fact that smaller institutions fared somewhat better. While smaller institutions, due to their more modest exposure to alternatives, might have experienced less severe losses, those losses nevertheless were staggering – projected to be 18 to 20% for the fiscal year ending June 30. While layoffs from administrative and investment staffs are occurring at many endowment and foundation offices, one wonders how far it is possible to “scale back” a one or two-person office. More importantly, should you? Small endowments and foundations typically rely on investment committees for investment oversight, with part-time administration by a member or two of the finance staff. Mid-sized endowments typically have only one or two people on staff dedicated to overseeing the investment portfolio. Cutting costs here appears challenging, and perhaps counter-productive, unless the functionality of the lost personnel is somehow replaced through other, more effective, options.

I have been in the institutional money management business for almost 25 years. I spent 5 years at a well-known endowment with assets over \$4 billion, and for the past 5 ½ years I was the Chief Investment Officer of a mid-sized endowment.

My mission upon joining the mid-sized endowment was to incorporate some of the same investment strategies used by larger endowments. In the beginning, things went smoothly, educating members of the investment committee about various asset classes they had not previously incorporated into the endowment mix, and bringing forth strong managers to lead those charges.

Progress was achieved as planned, and the number of managers increased from approximately 10 to 47. Why the substantial increase in managers? We made substantial allocations to alternative asset classes, where manager risk is among the most important challenges encountered. The best way to mitigate manager risk is twofold: strong due diligence, and diversification of managers.

It is vitally important to any investment program to meet with the managers frequently, not only for purposes of oversight, but to remain informed and “up to speed” regarding the managers’ current thinking, and to stay abreast of emerging opportunities. Quick math says that this requires a lot of meetings, and significant travel.

Now consider this growth in managers in context with the concomitant growth in asset classes utilized by many foundations and endowments: public equities (domestic and international), fixed income instruments, real estate, private equity, natural resources and hedge funds. Each of these broader strategies includes many nuances. While one person might be able to acquire a general working knowledge of all asset classes, few if any can

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<sup>2</sup> The Daily Tell, Zorabedian; 7-3-09

<sup>3</sup> The Daily Tell, Zorabedian; 7-3-09

<sup>4</sup> NACUBO 2007 Endowment Study

<sup>5</sup> While some tried to argue earlier this year that the diversified or endowment approach was somehow broken or unworthy, long-term performance continues to suggest otherwise.

maintain a current and in-depth knowledge of each.

At my former institution, the endowment increased its exposure to at least six asset classes and expanded its roster of managers by nearly five-fold. The plan was to hire staff to assist as the endowment portfolio grew in size and complexity. A great plan, until the market sold-off in the fall of 2008. With assets falling in the tumultuous markets, and tremendous new opportunities at the same time emerging, it was clear we needed more staff and resources. Budgetary pressures, however, were pushing forcefully in the opposite direction. With budgets under such pressure, how do you pay for added resources?

I began exploring various options and talking with other endowment heads. It seemed many endowments, even with staffs of two or more, were feeling the pressure of trying to cover too many bases. Managers were facing challenges, while other cracks and stresses in the system continued to appear at a rapid pace. Complicating the picture were new investment products – from the government, as well as from private management firms — that purported to take advantage of the widening market dislocation caused by the credit crunch. The government brought forth two new plans in 2009 – Term Asset Backed Loan Facility (TALF) and Public-Private Investment Program (PPIP). It takes a lot of time to understand these types of programs and perform due diligence on the managers poised to invest in these assets.

I ultimately came to the conclusion that I needed experienced people - and not just a few. Yet with the budget already in a squeeze, a new sort of solution would be required. After speaking with several sources and firms, I decided to approach my investment committee with the idea of outsourcing my role and myself.

I felt the plan I was suggesting was the best solution for my institution and an exceptional investment committee. It was time to live up to my belief that whatever is best for the endowment ultimately will be best for those who manage it. In any case, I did not want to enter the last phase of my career by letting my organization down. I still wanted to work for them and provide the best investment direction possible.

Fortunately, this story has a happy ending, because we were able to implement this plan. There happened to be a firm in my vicinity with a top research staff. In talks with them, we developed an outsourcing strategy that we felt would benefit all parties involved. The price was right for the endowment; the depth of resources was right. More importantly, the culture and investment philosophy aligned. So, after discussing the proposal with the investment committee and substantial due diligence by them, an agreement was struck to partner with me as an external CIO.

I left my institutional employer and began working for the consulting firm, which gave me immediate administrative and research support on a dollar cost-neutral basis for the university. Though the institution lost its CIO, few operational changes were caused by the new arrangement. The institution's Investment Committee retained final approval on main issues, while I, the now-outsourced CIO, gained immediate access to research and client support teams that was otherwise unavailable to me.

The endowment was presented with the challenge of addressing an expanded array of investment products in the midst of a global investment setback that constrained resources. The outsourced CIO solution was recommended and adopted as a means to access resources that were otherwise out of reach.

My experience convinces me that the out-sourced CIO option is worthy of consideration by mid-sized foundations and educational institutions in our fast-paced, ever changing economic and investment environment. It is my hope that they do so.

If you would like to discuss whether delegating some or all of your investment function makes sense, feel free to contact me.

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