BOARD OF REGENTS
BRIEFING PAPER

1. Agenda Item Title: Outsourced Chief Investment Officer Model Discussion

Meeting Date: 10/23/15

2. BACKGROUND & POLICY CONTEXT OF ISSUE:

The current investment model utilized by the System to support the selection of mangers, allocation of assets, and operation of the Investment pool is classified as an advisory model, where an investment advisor provides recommendations and alternatives for the Committee to consider, and the Committee is ultimately responsible for all of the actions and decisions, both policy and operational. An alternative model, existing for many years but popularized in recent years involves the outsourcing of some non-governance investment functions to firms with specialized investment management & operational expertise. This can allow for faster response to market demands, investment manager hiring/firing, strategic & timely rebalancing and other important operational functions. This model, commonly known as the Outsourced Chief Investment Officer (OCIO) model, can also allow Investment Committees time to focus its time on strategic initiatives and fiduciary oversight of the investment pool while utilizing the OCIO to perform day to day functions of the Investment Pool.

The Investment and Facilities Committee has directed System staff to look at the OCIO model, and this topic has been discussed at the Committee during the past year. At the June, 2015 meeting the Committee directed the Vice Chancellor of Finance to evaluate and hire, as appropriate, a consultant to assist in navigating the process for evaluating this model and conducting a request for proposal for an OCIO. The firm selected through a solicitation was Your Second Opinion, LLC.

Russell Campbell, CEO of Your Second Opinion, LLC, has prepared the attached report detailing the OCIO option and discussing several options for how this program may be beneficial to NSHE. As the next step in the process, Committee Chair Melcher has convened this special Investment and Facilities Committee meeting to discuss the model and, as appropriate, provide direction to staff for next steps which may include development of a Request for Proposal (RFP).

Note: two documents have been included with the board packet; the document titled “Investment Management Models – Outsourced Chief Investment Officer Background Document” is a detail analysis and report of the current NSHE investment model and the OCIO model; the document titled “October 23 Workshop Discussion Document Investment & Facilities Committee Board of Regents” will be used during the meeting to help facilitate discussion and decision making.

3. SPECIFIC ACTIONS BEING RECOMMENDED OR REQUESTED:

Committee Chair Melcher will lead a Committee discussion to: 1) consider the Outsourced Chief Investment Officer model analysis presented to by Russell Campbell of Your Second Opinion, LLC and determine the appropriateness of this model for NSHE, and 2) direct staff and Your Second Opinion, LLC, to prepare a Request for Proposal for the selection of an Outsourced Chief Investment Officer to be approved at a future Investment and Facilities Committee meeting.

4. IMPETUS (WHY NOW?):

The current advisor contract will expire in September of 2016. If the Committee chooses to move to an OCIO model upon expiration of the current advisor contract, the RFP process and an OCIO search would need to begin several months in advance of the expiration date.

5. BULLET POINTS TO SUPPORT REQUEST/RECOMMENDATION:

- Investment related decisions such as manager selection and termination can occur more timely under an OCIO model.

- An OCIO model would reduce the Investment Committee's responsibility of oversight of day to day operations allowing for more focus on long term strategic planning and governance of Investment pool activities.

6. POTENTIAL ARGUMENTS AGAINST THE REQUEST/RECOMMENDATION:

Implementation of an OCIO model could result in net increased fees or costs for the Investment Pool(s).

7. ALTERNATIVE(S) TO WHAT IS BEING REQUESTED/RECOMMENDED:

Continue with the current advisory investment model

8. COMPLIANCE WITH BOARD POLICY:

❑ Consistent With Current Board Policy: Title #_____ Chapter #_____ Section #_______
❑ Amends Current Board Policy: Title #___ Chapter #___ Section #____
❑ Amends Current Procedures & Guidelines Manual: Chapter #_____ Section #______
❑ Other:____
❑ Fiscal Impact: Yes_x___ No_____
Explain: __depending on the results of the RFP and which, if any, tasks are outsourced there could be an increase in fees for the OCIO over the current advisor model. Likewise, there could be an offsetting reduction in costs associated with internal staffing and current fund-of-fund investment manager fees. The net calculation is dependent on the model and level of outsourcing selected.

Nevada System of Higher Education

INVESTMENT MANAGEMENT MODELS - OUTSOURCED CHIEF INVESTMENT OFFICER (OCIO)

Background Document

Prepared by:
Russell Campbell
Your Second Opinion, LLC

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Executive Summary

The investment management of large pools of assets, such as those administered by NSHE, requires both effective governance and implementation. Outsourcing the chief investment officer (OCIO) answers most of the critical investment challenges involved in managing endowment and operating pools, and provides a clear path to effective governance. This report addresses the OCIO model of managing investment portfolios.

Introduction

The Board of Regents and the Investment and Facilities Committee have delegated certain investment activities to others. For example, investment managers select individual securities. These investment managers remain accountable for their actions to the NSHE Board of Regents.

Not all investment activities are delegated. The Board does not delegate critical functions such as asset allocation and money manager selection. From a governance perspective, delegating these responsibilities could be considered a best practice.

A dedicated Chief Investment Officer (CIO) would have the time, resources and expertise to manage, not just oversee, the most critical investment tasks.

The challenge is that the cost of hiring a qualified CIO, and needed staff is high. Many endowments, and the owners of similar asset pools, have chosen to outsource critical investment responsibilities, instead of adding to their own staff.

Not all responsibilities can, or should be delegated, to an Outsourced Chief Investment Officer (OCIO). Developing an investment policy, vetting and monitoring staff and service providers are examples of responsibilities that can't be delegated.

OCIO is not for everyone. But OCIO offers a solution that is perceived as effective by many other funds that are similar to NSHE.

NSHE Policies and Results

Before considering any changes to an investment model, it is important to review the effectiveness of the existing approach. It is evident that NSHE has had policies and procedures in place that have helped the endowment and operating pools to achieve their goals.

Investment performance has been excellent since inception in comparison to both the policy benchmark and the performance of other endowments.

As of June 30, 2015:

- Annualized since 6/30/84 = 10.4%
- Value Added versus Policy Index since inception = +0.2%
- 10 Years vs. Endowment Universe = 7.2% (27th percentile)

NSHE has formal investment objectives and policies for the endowment and the operating pools. Here is a summary:

Endowment

- Time horizon – 10 years
- Objectives: match inflation, inflation + 4.5% spending rate (net of fees)
- Distributions: up to 4.5% (MV of previous 20 quarters, up to 1.5% mgmt. fee to institutions, current max 4.75%, 0.125% mgmt. fee
- Allocation: 77% Equity (35% domestic common, 13% international common, 19% alternative strategies, 10% real estate and other inflation hedges), 23% Fixed (normally AA minimum, normally 3 year duration, 35% maximum in non - $), derivatives require authorization
- Benchmarks: Inflation + 4.5% spending rate over 10 year rolling periods, capital market benchmarks weighted by strategic allocation over 5 year rolling periods, median returns of other similar endowments over 10 year rolling periods

Operating

- Time horizon – 10 years
- Objectives: match inflation over 10 year rolling periods
- Three pools: Short – term (daily cash needs, fixed income less than 1 year maturity), Intermediate – term (back-up for short – term pool, fixed income less than 3 years maturity), Long – term (fixed income, TIPS, Equity, absolute return)
- AA average quality, A minimum
- Derivatives for hedging or efficient implementation
- Distributions: Monthly, based on spending rate, market fluctuation account

Responsibilities and Delegation

The Great Recession of a few years ago disrupted and dislocated the capital markets. The resulting financial crisis prompted many changes in investment practices.

Managing large pools of assets begins with governance - who is responsible for what. Top down governance alone cannot keep up with the demands of managing large portfolios today. It takes more time than most Boards have available, significant resources and considerable expertise.

Here are some examples of how much more difficult it is to manage large investment pools like NSHE.

1. There are more asset classes used by asset owners like NSHE than there used to be. Even the definition of an asset classes has become murkier. Many asset classes show a high correlation to the equity markets for example. This complicates efforts to ensure portfolio diversification.
2. There are more investment managers than ever before. There are more than 20,000 institutional quality money managers.
3. There are more investment vehicles (funds and securities), and products offered by investment managers. There are over 100,000 investment products available.

The NSHE is responsible for overseeing a large endowment pool and a large operating pool. The staff supporting this effort is small, and has multiple responsibilities. There has been turnover in staff over the years, which means that institutional and investment knowledge is lost each time someone leaves. Similarly, the Investment and Facilities Committee of the Board of Regents has a broad mandate and limited time.

The investment consulting firm that is retained by NSHE is a linchpin offering both continuity and expertise. Their missing role however, is accountability. All of the major responsibilities rest directly and solely, with the Committee.

The Committee's responsibilities begin with considering spending and liquidity policies. The Committee then approves an appropriate investment policy. The Committee is also responsible for the following major decisions:

- Deciding on suitable asset classes
- Selecting acceptable investment strategies
- Determining which investment vehicles can be used
- Manager selection
- Determining long term asset allocation
- Making short term tactical asset allocation changes if necessary
- Setting investment performance benchmarks
- Negotiating manager fees and contract terms
- Risk management
- Cash flow and liquidity
- Transition management
- Relationships with service vendors

Asset Allocation and Manager Selection

Asset allocation and manager selection are the largest contributors to the investment performance of the NSHE pools.

Asset Allocation

The NSHE endowment has a strategic asset allocation of 77% equities and 23% bonds. This is a long – term allocation that is based on a model of historic and expected returns.

A long - term strategic allocation is unlikely to be the best decision over shorter time periods.

Looking back at the endowment's asset allocation, it varies very little over time.

There should be a process and a procedure in place to consider changes in asset allocation - if needed or desired.

The operating pool has a larger deviation from its long - term strategic allocation. But the amount of the variation has remained stable over time. Like the endowment pool, there seems to be little variation in the operating pool from the long - term allocation.

Manager Selection

The endowment has 22 managers, and the operating pool has 14. Of the endowment's 22 managers, 8 are alternative managers - and there are 14 private investment partnerships. The number of managers is not unusual given the amount of assets under management.

Implications

A static approach to asset allocation is unusual. Capital markets movements cause shifts in asset allocation. This suggests that the pools are being rebalanced to the long term strategic asset allocation. Rebalancing is an active decision.

The long term strategic allocation is based on an academic model of expected future returns. Actual future returns may be significantly different than those expected by any model. Second, there should be a process and procedure in place to deviate from the long term asset allocation over shorter time periods.

Lastly, the number of money managers involved with the NSHE pools hints at the underlying complexity in managing these two pools of assets.

The expertise and resources required to manage the NSHE endowment and operating pools is significant.

OCIO versus Investment Consulting

One of the biggest providers of OCIO services are current or former investment consulting firms (including the current investment consultant retained by NSHE). There are some similarities, but also some significant differences between investment consulting and OCIO.

Investment Consultant

- NHSE remains solely responsible for both strategic and tactical asset allocation and manager selection
- NSHE is highly dependent on investment consultant recommendations
- Only anecdotal evidence exists of a consultant's track record
- There is a lengthy process to make asset allocation or money manager changes
- Consultant is not responsible for decisions or investment results
- Consultants are advisors only – no fiduciary responsibility is expressed or implied

OCIO

- NSHE would delegate additional responsibilities in order to maintain focus on governance
- Formal accountability framework
- Some limited sharing of fiduciary responsibility with the OCIO may be possible
- Faster and possibly more timely changes in asset allocation and manager selection
- Possible access to difficult to hire money managers
- Combined buying power with other OCIO clients to meet minimums and exceed fee breakpoints (lower fees)
- Possible enhancement to risk management
- Possible assistance with asset - liability and liquidity modelling
- Possible administrative support (cash calls, transitions)
- Execution/transition/implementation services

Industry Practices & Trends

Some asset owners have used, what we now call, outsourced chief investment officers, for many years. In simple terms, it involves delegating day – to –day investment responsibility and accountability to a third-party. Here are several surveys that summarize why other asset owners have chosen the OCIO route.

Chatham Partners (2013)

- **Limited internal staff time**
- **Need to improve risk management**
- **Enhance fiduciary services and oversight**
- **Quicken reactions to market conditions**
- **Improve operational efficiencies**
- **Quicken manager hire and fire decisions**

AI – CIO (2015)

- **Lack of internal resources**
- **Desire for better risk management**
- **Faster implementation/decisions**
- **Additional fiduciary oversight**

Here are some additional reasons to consider OCIO.

- **Clarify the differences between governance and day – to – day investment decision – making**
- **Create an accountability framework for investment results**
- **Improve documentation of investment processes, procedures, reporting and compliance**
- **Access needed technology e.g. risk management, cash flow modelling, asset – liability modelling**

A recent survey by Casey Quirk & Associates (2014) projected the growth in usage of OCIO by non – profit organizations. This is a growing trend amongst asset owners like NSHE.

2012 – $170 Billion
2013 – $198 B
2014e – $228 B
2015e – $263 B
2016e – $301 B
2017e – $343 B
2018e – $391 B

Types of OCIO

OCIOs have emerged from a number of different sources. Some were large investment consulting firms that chose to either continue offering both OCIO and investment consulting services or now focus on OCIO exclusively. Other OCIO firms have been established by former CIOs of endowment funds. Some of the largest money managers offer their own version of OCIO, often using their own funds. And there are other independent firms also offering these services.

OCIO firms select their own suite of money managers (which are likely to be different from the current NSHE line – up).

Some OCIO firms manage some money in – house. These activities should be reviewed for any signs of conflict of interest.

What is Best Practice in Fund Governance?

McKinsey and Company (2014) examined the performance of 40 of the world's largest institutional investors from 2004 to 2011. They split the group into "overachievers" and "underachievers". The investment performance of the two groups was similar. However, the "overachievers" were able to earn their returns with half of the volatility of the "underachievers".

Lower volatility is important for the NSHE endowment and operating pools as it ensures stability in the spending rate.

Over 100 senior leaders from the overachieving firms were interviewed. The conclusion was that their superior results (similar investment returns but at lower risk) were the result of their focus on 5 key areas: mandate, governance model, investment philosophy, investment strategy and processes and talent management.

Governance included policies, guidelines and decision rights. There are four principles of good governance mentioned in the summary of this survey:

- **Clear accountabilities**
- **Board competence**
- **Efficient decision – making**
- **Effective fiduciary control**

Current Priorities of Other Large Funds

The "Great Recession" heightened the pressure on asset owners like NSHE to improve their responses to an increasingly complex investment environment. A CREATE Research (2014) survey of large institutional asset owners asked how their approach to overseeing their funds was changing. Their efforts fall into three categories – governance practices, asset allocation and strategy execution. Within each of these three categories, there were 5 specific items mentioned as priorities. Many of the concerns expressed in this survey may also be applicable to NSHE. An OCIO provider could help to address these general concerns.

Governance Practices:

- **Improve clarity of plan – e.g. mission**
- **Improve clarity of investment beliefs and time horizon**
- **Add investment expertise to Board**
- **Clarify roles between Board and staff**
- **Consider an in – house CIO**

Asset Allocation:

- **Diversify by risk factors, not just asset classes**
- **Consider more dynamic investing**
- **Additional alternative investments**
- **Consider absolute return strategies**
- **Add real assets**

Strategy Execution:

- **Risk management modelling**
- **Considering different kinds of investment vehicles**
- **Value – for – money fee structures**
- **Improving performance attribution**
- **Improve manager strategies**

Why Some Asset Owners Consider, But Don't Use an OCIO

Some asset owners consider OCIO but choose not to delegate any further responsibilities.

- *Some asset owners worry that they will choose the wrong OCIO*. Later we'll see several industry surveys that suggest that after – purchase satisfaction is high
- *Concern about giving up open architecture*. Theoretically every money manager is available to an asset owner like NSHE. Practically this is not true. While an OCIO provider limits choice, they also own the accountability for their efforts. And because of OCIO buying power, they may be able to hire money managers who only accept very large investment mandates.
- *Less access to the thought leadership of money managers*. NSHE relies on its investment consultant, not money managers for access to thought leadership.
- *How to deal with legacy assets and managers, if they cannot be liquidated*. This is a real issue. The OCIO provider will either liquidate existing investments in order to establish their own portfolio, or the OCIO selected must agree to oversee these legacy assets or managers.

Here are some additional reasons from two industry surveys of asset owners who chose not to hire an OCIO.

Chatham Partners (2013)

- Have expertise and resources to handle internally
- Would result in higher costs
- Investment consultant provides the necessary support
- Outsourcing would not likely result in outperformance
- Do not believe co – fiduciary services add value
- Fund is too big to outsource

AI – CIO (2014)

- Want to retain full control
- Have investment expertise in – house
- Other reasons: Cost concerns, no support from board, prefer to rely on investment consultant

How Much to Outsource and Delegate

NHSE will have the ability to tailor many aspects of the OCIO relationship. And there are some structural choices that can be made in advance as well.

1. Full or Partial Outsourcing of Assets

Two separate industry surveys indicate that of those who choose to outsource, most choose to outsource 100% of their assets to OCIO. A minority retain full control over some assets (up to 25%). This may be because they have internal investment expertise or because control of the assets cannot be outsourced. Another minority of asset owners only outsources control over less than 25% of assets. This could be because of a choice to delegate control over more complex assets only (e.g. alternatives).

SEI Investments (2014)	Chatham Partners (2013)
100% outsourced = 57% of asset owners	100% outsourced = 48% of asset owners
75%+ = 14%	75%+ = 17%
50% + = 8%	50%+ = 6%
25% + = 3%	25%+ = 6%
<25% = 17%	<25% = 23%

2. Full or Partial Discretion Over Asset Allocation, Manager Decisions

A separate survey from SEI Investments (2013) indicated of those asset owners that choose to outsource, 47% outsource asset allocation decisions and 45% outsource manager decisions. NSHE can choose which elements to outsource and to what extent.

3. Full or Partial Discretion to One or More OCIOs

There are at least 4 possible approaches to outsourcing.

1. Hire one OCIO
2. Hire two firms with similar styles
3. Hire two firms with complementary styles – perhaps one is stronger with alternatives than the other, for example
4. Hire two firms – one with broad – based skills and the other with highly specialized skills such as risk management.

After the Transition: Typical Buyer Satisfaction With Their OCIO Decision

There are two industry surveys that both indicate that asset owners who chose an OCIO are on balance, satisfied with their decision.

Chatham Partners (2013) surveyed OCIO users on their satisfaction with the service. Five criteria were considered – Investment performance, Risk management, Meeting goals, Client service, Reporting. On a scale of 1 - 7, client satisfaction was 4 (average) or better on each of the 5 criteria for between 96 and 98% of clients.

Another survey by SEI Investments (2014) found that of those using OCIO, 32% plan to increase outsourced assets in 2015, 52% will remain the same, 8% plan to reduce OCIO and 4% don't know.

Overall, satisfaction appears to be high for those who have chosen the OCIO route.

Sample Questions for the Committee to Consider

- Does the current structure of responsibility and accountability reflect best practices from a both a governance and an investment perspective?
- Does the Committee have the time, resources and expertise to directly manage the critical investment tasks?
- Does the Committee have the time to address governance issues? Examples include investment beliefs, time horizon, active versus passive management, comprehensive risk assessment, liquidity, fee structures and amounts paid, service provider quality
- Should asset allocation be fixed or dynamic?
- Should there be a process to more dynamically shift asset allocation?
- Should the Board be directly accountable for manager selection?
- Are there tasks that are not being done? Examples could include risk management, cash low modelling, asset – liability modelling.
- How much control does the Committee wish to retain if the decision is made to use an OCIO?
- What percentage of the pools will be outsourced?

Continuing Responsibilities of the Board/ Committee Post Outsourcing

- Monitor OCIO quarterly – relative and absolute investment performance and strategy, OCIO investment process & people, adherence to investment policies, fee calculations, outsourcing additional assets (if less than 100% initially)
- Consider additional or replacement OCIOs
- Spending & liquidity policies
- Investment policy
- Investment policy evolution – e.g. consider active vs. passive, use of alternative assets, risk management, asset/liability modeling
- Total fees and terms of agreements with service providers

Possible Decisions by NSHE Arising From Workshop

- Continue with status quo – Board of Regents, Investment & Facilities Committee, Internal Staff, Current investment consultant
- Update governance framework to clarify mission, roles, accountabilities
- Build a robust internal investment capability accountable to the Board
- Delegate certain fund responsibilities to an OCIO with accountability to the Board

If the decision is made to consider an OCIO, the Committee or the Board could suggest certain selection factors.

Selection Factors

NSHE should determine its own list of selection factors if it chooses to consider an OCIO provider. However, it is worthwhile to review the selection factors used by other users of OCIO services. The following list is from an industry survey.

Chatham Partners (2013)

Investment Capabilities & Services

- Asset allocation expertise
- Multi – asset class coverage/expertise
- Demonstrable outperformance
- Alternative assets expertise
- Global assets expertise
- ALM expertise
- Product agnostic advisory team
- Open architecture
- LDI expertise

Firm Attributes & Service Models

- Reputation and financial stability of team
- Experience and seniority of staff
- Experience as an OCIO
- Client service model
- Operational and admin capabilities
- Fiduciary services
- Customized services
- Cost
- Regulatory and fiduciary education
- Current or past relationship
- Size of firm

Two Challenges for Diligence: Track Record & Fees

Examining the Track Record

One of the challenges in selecting an OCIO provider is understanding their track record. Since one of the key advantages of using an OCIO is to improve long –term performance, the difficulty in understanding past performance can be a hurdle to hiring an OCIO. Here are some of the issues with performance presentations by potential providers.

- Not every OCIO adheres to industry performance presentation standards (GIPS). There are often good reasons for the lack of standardization but it makes it more difficult to judge past OCIO skill
- One of the reasons that it is difficult to get composite returns from OCIO providers is that their clients often have highly customized portfolios e.g. asset mix and manager selections vary between clients
- Performance may not be presented in relation to risks assumed
- Net of fees performance not always presented
- Performance of traditional asset classes should be separately presented
- Performance of alternatives asset classes should be separately presented
- Active, passive or hybrid investment management approaches may affect performance
- Track record may be short

Examining the Fees Charged

It is important to have an understanding of your fund's total current fees. Also, consider the enhancements and cost savings available from adopting the OCIO approach. But there is another challenge. Understanding the fees charged by an OCIO provider is complicated.

- OCIO management fee – the estimated range quoted by industry sources is .30% to 1.00% but the amount of assets, services provided and negotiation skills will generally result in a lower fee. There are also some potential offsets (e.g. lower manager fees)
- There may be a minimum fee.
- There may be an OCIO performance incentive fee
- Custody fees are additional but should be similar to what you pay now
- The fee for traditional (equity, bond) money managers may be included in a bundled OCIO fee, or passed through separately
- The fee for alternative managers (hedge funds, real estate, private equity) may be included in a bundled OCIO fee, or passed through separately
- If fees are included in a bundled OCIO fee, there is an economic incentive for the OCIO to try to hire lower fee managers – this should be reviewed
- Asset allocation and the choice of active or passive investment management will influence the total fee
- Some OCIO providers have proprietary funds or affiliates that share revenues with the OCIO. These are usually disclosed, but can be a source of conflict of interest – this should be reviewed.

Transition Issues

Once the decision is made to use an OCIO vendor, there will be a number of transition issues to consider. For example;

- Will NSHE delegate 100% or less of the assets?
- Will the transfer be in cash, or in – kind allowing the OCIO to make the transition to their own suite of money managers?
- If NSHE holds assets that are illiquid, will the OCIO vendor agree to monitor the assets?
- The NSHE Investment policy will need to be revised
- OCIO compliance and operations should be reviewed
- All potential conflicts of interest should be reviewed
- Contracting with OCIO – clearly define each parties responsibilities
- Contracting by OCIO with investment managers – rights of NSHE

Authors Bio

Russell Campbell is the CEO of Your Second Opinion, LLC, a management consulting firm offering advice to investment management organizations.

Russell has led 5 investment groups in his career. Prior to establishing his own firm in 2011, Russell was the CEO of The Marco Consulting Group, one of the largest institutional investment consulting firms, with a significant CIO outsourcing business. Previously, he was the EVP of AMCORE Bank, leading the Wealth Management Group which was one of the 60 largest bank wealth managers in the U.S.. Earlier, Russell was the President and CEO of ABN AMRO Asset Management Holdings, Inc., which managed $75 billion in assets, and was the U.S. investment management affiliate of ABN AMRO Bank. He was a member of the Global Asset Management Committee which oversaw more than $200 billion in assets worldwide. Russell was promoted after having been the CEO of ABN AMRO Asset Management Canada, Inc. He was previously the Vice – President and Partner of Beutel Goodman, Inc., one of Canada's largest investment counseling firms. His first leadership position was as Vice – President, Bank of Nova Scotia, where he led the investment management of the Bank's own pension fund, and a large international family office portfolio.

Earlier in his career, he was an institutional investment consultant, an institutional equity salesperson and a precious metals portfolio manager.

Russell has an MBA in Investment Finance and Marketing from York University, and a BA in Industrial Relations from McGill University. He also attended the Advanced Management Program at INSEAD in France.

He has earned the Chartered Financial Analyst designation, and has attended both the Financial Analyst's Seminar and the Investment Management Workshop. Russell has also acquired the Certified Financial Planner ™ certification. He previously held Series 7 and 24.

Russell has been a director of several for-profit and not for profit boards, and is a member of numerous local, regional and national non-profit, civic and industry organizations.

He is quoted frequently in the media, and has been a speaker at many industry conferences.

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Nevada System of Higher Education

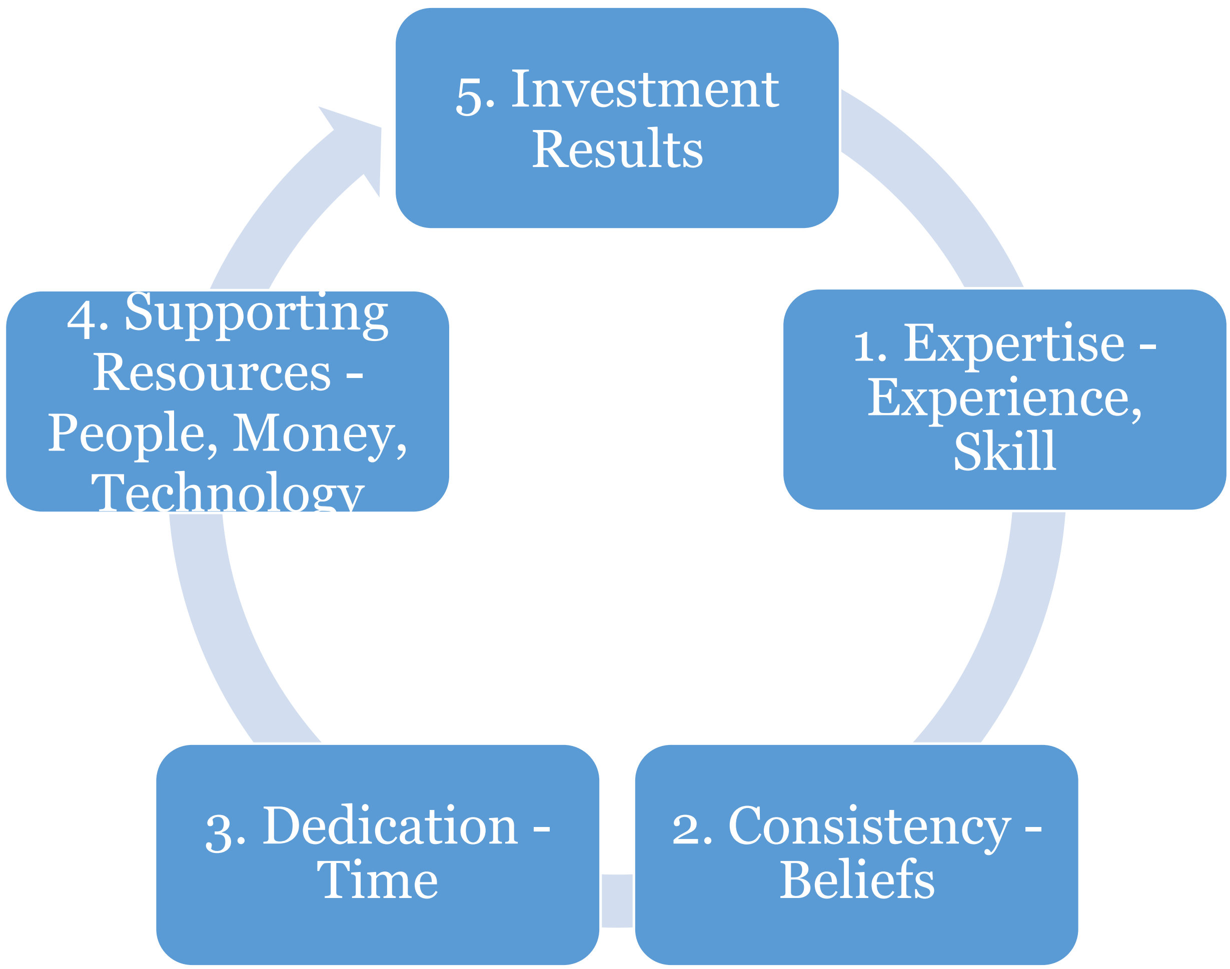
INVESTMENT MANAGEMENT MODELS - OUTSOURCED CHIEF INVESTMENT OFFICER (OCIO)

October 23 Workshop Discussion Document
Investment & Facilities Committee
Board of Regents

Prepared by:
Russell Campbell
Your Second Opinion, LLC

Part I – Investment Model Review

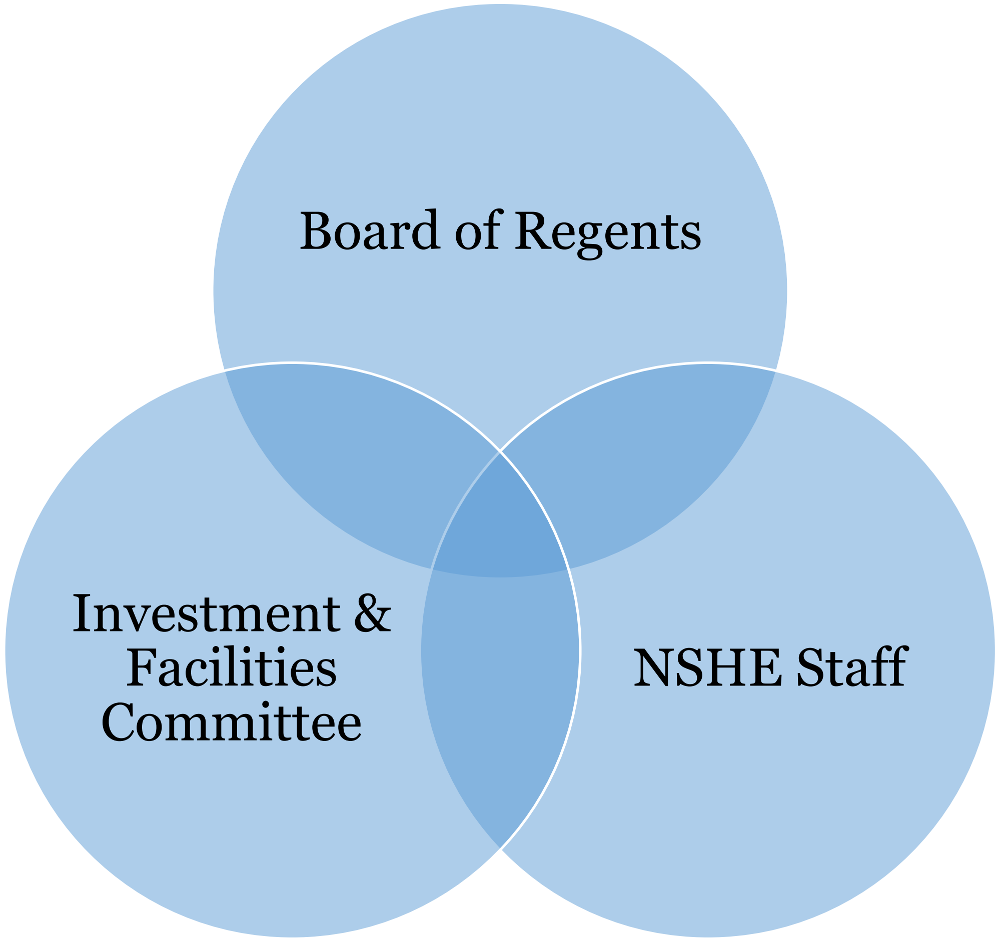
Overview of a Typical Investment Model



Implementation?

1. DIY - Board/Committee/Administrative Staff
2. Specialized internal investment staff
3. External advisors
4. Some combination of above options

Fiduciary Oversight and Accountability



Fiduciary Responsibilities

The Committee's responsibilities begin with considering spending and liquidity policies. The Committee then approves an appropriate investment policy. The Committee is also responsible for the following major decisions:

- Deciding on suitable asset classes e.g. real estate
- Selecting acceptable investment strategies e.g. derivatives
- Determining which investment vehicles can be used e.g. TIPS
- Manager selection e.g. Manning & Napier
- Time horizon e.g. 10 years
- Determining long term asset allocation e.g. 77% equity, 23% fixed income
- Making short term tactical asset allocation changes (if desired or required)
- Setting investment performance benchmarks e.g. Inflation + spending rate
- Negotiating manager fees and contract terms e.g. value for fees paid
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Investment Results

Before considering any changes to an investment model, it is helpful to review the results of the existing approach. NSHE has policies and procedures in place that have helped the endowment and operating pools to achieve their goals.

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- Annualized since 6/30/84 = 10.4%
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Nothing appears to be broken at this time. Investment results have outperformed the benchmarks established.

What are Best Practices in Fund Governance?

McKinsey and Company (2014) examined the performance of 40 of the world's largest institutional investors from 2004 to 2011. They split the group into "overachievers" and "underachievers". The investment performance of the two groups was similar.

However, "overachievers" were able to earn their returns with half of the volatility of the "underachievers".

Lower volatility is important for the NSHE endowment and operating pools as it ensures stability in the spending rate.

Over 100 senior leaders from the overachieving firms were interviewed. The conclusion was that their superior results (similar investment returns but at lower risk) were the result of their focus on 5 key areas: mandate, governance model, investment philosophy, investment strategy and processes and talent management.

Governance included policies, guidelines and decision rights. There are four principles of good governance mentioned in the summary of this survey:

• **Clear accountabilities**	• **Should NSHE make key accountabilities clearer?**
• **Board competence**	• **Does the Board/Committee have the investment acumen and the time to be effective?**
• **Efficient decision – making**	• **Is investment decision – making efficient?**
• **Effective fiduciary control**	• **Does the Committee have effective fiduciary control over all accountable parties?**

Case Study: NSHE Asset Allocation and Manager Selection

Asset allocation and manager selection are the largest contributors to the investment performance of the NSHE pools.

Asset Allocation

The NSHE endowment has a strategic asset allocation of 77% equities and 23% bonds. This is a long – term allocation that is based on a model of historic and expected returns.

A long - term strategic allocation is unlikely to be the best decision over all shorter time periods. It is a choice to avoid short term allocation changes. But if there is a significant shift in asset values, there may be the need to take action to avoid risk or to capture unusual return opportunities.

Looking back at the endowment's asset allocation, it varies very little over time.

There should be at a minimum, a timely process and a procedure in place to consider changes in asset allocation - if required or desired.

The operating pool has a larger deviation from its long - term strategic allocation. But the amount of the variation from the longer term allocation has remained stable over time. Like the endowment pool, there seems to be little variation in the operating pool from the long - term allocation.

Manager Selection

The endowment has 22 managers, and the operating pool has 14. Of the endowment's 22 managers, 8 are alternative managers - and there are 14 private investment partnerships. The number of managers is not unusual given the amount of assets under management.

Implications

A static approach to asset allocation is unusual. Capital markets movements cause shifts in asset allocation. This suggests that the pools are being rebalanced to the long term strategic asset allocation. Rebalancing is an active decision. And it is one of many possibilities.

The long term strategic allocation is based on an academic model of expected future returns. Actual future returns may be significantly different than those expected by any model. Second, there should be a process and procedure in place to deviate from the long term asset allocation over shorter time periods.

Lastly, the number of money managers involved with the NSHE pools hints at the underlying complexity in managing these two pools of assets.

The expertise and resources required to manage the NSHE endowment and operating pools is significant.

! Discussion Point: Does Current Asset Allocation and Manager Selection Meet Best Practice Recommendations

Governance Criteria	Manager Selection/Asset Allocation
1. Clear accountabilities? (e.g. the relative contributions of each party are measureable)	
2. Board Competence (& Resources) (e.g. time is available)?	
3. Efficient decision – making? (e.g. timely decisions)	
4. Effective fiduciary control? (e.g. identify who researches, advises, decides, monitors)	

! Discussion Point: Committee Level Governance Questions

- Does the current structure of responsibility and accountability reflect evolving best practices from both a governance and an investment perspective?
- Does the Committee have the resources and expertise to directly manage critical investment tasks such as manager selection and (short – term) asset allocation?
- Who should be held directly accountable for investment results – money managers, investment consultant, staff, Committee, Board?
- Should the Committee measure its own contribution to investment results?
- Does the governance framework accommodate changes in the members of the Committee/Staff over time?
- What does the Committee believe is true about investing? Are these beliefs supported by evidence and reflected in the portfolio? e.g. the composition of the portfolios reflect a belief that security selection by active managers is superior to passive investing, and that a relatively fixed approach to long term asset allocation is superior to tactical short term asset allocation.
- Is tactical (short – term) asset allocation desired or needed?
- If the equity market falls by 30%, how much will the endowment and operating pools decline?
- Do you pay the lowest fees available from each manager? How is this confirmed?
- Is your exposure to alternatives too low, too high or just right? What is the basis for this conclusion?
- Can the monitoring of risks be enhanced? Market, service provider etc.
- How effective is the oversight of liquidity, implicit and explicit financial leverage (e.g. debt, derivatives)?
- Are there tasks that could be done more effectively? Examples could include risk management, cash flow modelling, asset – liability modelling.

! Discussion Point: Is it the Right Time to Consider a Different Model?

- Rising investment implementation complexity – investment products & services, investment vehicles, tactical options
- Volatile markets present both risk and extraordinary opportunities
- Increasing attention by fiduciaries to importance of good governance
- The Board delegates many tasks already - but not the most critical and complex ones ((short –term) asset allocation, manager selection) that require tremendous resources, expertise and dedication.
- Headline risk – any one investment may appear, or even actually be, risky, yet in a portfolio, it may lower overall risk through diversification
- Headline risk – one high profile bad investment may present a PR challenge for the Board/Committee - who is currently solely accountable
- Enhancing the governance framework can help to ensure that investment results continue to be good.
- Decisions like these should be made when conditions are calm – not under duress

Discussion Point: Part 1 Conclusions

Part II – Outsourced Chief Investment Officer (OCIO)

OCIO versus Investment Consulting

There are over 100 vendors of OCIO services. Current or former investment consulting firms (such as the investment consulting firm retained by NSHE) often provide OCIO services. There are some similarities, but also some significant differences between retaining an investment consultant versus delegating to an OCIO.

Investment Consultant

- NHSE is solely responsible for strategic and tactical asset allocation, manager selection and many other investment – related decisions
- NSHE is highly reliant on investment consultant recommendations
- Only anecdotal evidence exists of an investment consultant's track record and little analysis of the contributing factors to results is available
- There may be delays in making asset allocation or money manager changes because NSHE needs to approve
- Consultant is not responsible for decisions or investment results
- Consultants are advisors only – no fiduciary responsibility is expressed or implied

OCIO

- NSHE could delegate additional responsibilities in order to maintain its focus on governance issues reflecting the available resources and expertise of the Committee
- There is a formal accountability framework
- Some sharing of fiduciary responsibility with the OCIO may be possible (though this is not yet tested in courts)
- More timely changes in asset allocation and manager selection may be possible
- Possible access to difficult to hire money managers through OCIO connections
- Combined buying power with other OCIO clients to meet minimum asset levels and exceed fee breakpoints (result is lower fees)
- Possible enhancement to risk management oversight
- Possible assistance with asset - liability and liquidity modelling
- Possible administrative support (e.g. cash calls, transitions, custodian & audit support)
- Execution/transition/implementation services

! Discussion Point: What are the benefits and the risks of relying on an investment consultant versus delegating to an OCIO?

Industry Challenges & Response

OCIO has been around for decades. In simple terms, it involves delegating some or all day – to –day investment responsibility and accountability to a third-party offering the resources and expertise. Here are several surveys that summarize why other institutional asset owners have chosen an OCIO.

Chatham Partners (2013)

- Limited internal staff time
- Need to improve risk management
- Enhance fiduciary services and oversight
- Quicken reactions to market conditions
- Improve operational efficiencies
- Quicken manager hire and fire decisions

AI – CIO (2015)

- Lack of internal resources
- Desire for better risk management
- Faster implementation/decisions
- Additional fiduciary oversight

Here are some additional reasons to consider OCIO.

- Clarify the differences between governance and day – to – day investment decision – making
- Create an accountability framework for investment results
- Improve documentation of investment processes, procedures, reporting and compliance
- Access needed technology e.g. risk management, cash flow modelling, asset – liability modelling

A recent survey by Casey Quirk & Associates (2014) projected the growth in usage of OCIO by non – profit organizations. This is a growing trend amongst asset owners like NSHE.

2012 – $170 Billion
2013 – $198 B
2014e – $228 B
2015e – $263 B
2016e – $301 B
2017e – $343 B
2018e – $391 B

! Discussion Point: How many of these industry challenges are also true for NSHE?

- Limited internal staff time/Lack of internal resources
- Need to improve risk management/ Desire for better risk management
- Enhance fiduciary services and oversight/ Additional fiduciary oversight
- Quicken reactions to market conditions
- Improve operational efficiencies
- Quicken manager hire and fire decisions
- Faster implementation/decisions
- Clarify the differences between governance and day – to – day investment decision – making
- Create an accountability framework for investment results
- Improve documentation of investment processes, procedures, reporting and compliance
- Access needed technology e.g. risk management, cash flow modelling, asset – liability modelling

! Discussion Point: Why Some Asset Owners Consider, But Don't Use an OCIO

- Want to retain full control
- Investment consultant provides the necessary support
- Prefer to rely on investment consultant
- Outsourcing would not likely result in outperformance
- Do not believe co – fiduciary services add value
- Would result in higher costs
- Have expertise and resources to handle internally
- Have investment expertise in – house
- Fund is too big to outsource
- May choose wrong OCIO.
- Concern about giving up open architecture.
- Less access to the thought leadership of money managers.
- How to deal with legacy assets and managers, if they cannot be liquidated

! Discussion Point: How Much to Outsource and Delegate

NHSE will have the ability to tailor many aspects of the OCIO relationship. And there are some structural choices that can be made in advance as well.

- **Full or Partial Outsourcing of Assets**

Two separate industry surveys indicate that of those who choose to outsource, most choose to outsource 100% of their assets to OCIO. A minority retain full control over some assets (up to 25%). This may be because they have internal investment expertise or because control of the assets cannot be outsourced. Another minority of asset owners only outsources control over less than 25% of assets. This could be because of a choice to delegate control over more complex assets only (e.g. alternatives).

SEI Investments (2014)	Chatham Partners (2013)
100% outsourced = 57% of asset owners	100% outsourced = 48% of asset owners
75%+ = 14%	75%+ = 17%
50% + = 8%	50%+ = 6%
25% + = 3%	25%+ = 6%
<25% = 17%	<25% = 23%

- **Full or Partial Discretion Over Asset Allocation, Manager Decisions**

A separate survey from SEI Investments (2013) indicated of those asset owners that choose to outsource, 47% outsource asset allocation decisions and 45% outsource manager decisions. NSHE can choose which elements to outsource and to what extent.

- **Full or Partial Discretion to One or More OCIOs**

There are at least 4 possible approaches to outsourcing.

1. Hire one OCIO
2. Hire two firms with similar styles
3. Hire two firms with complementary styles – perhaps one is stronger with alternatives than the other, for example
4. Hire two firms – one with broad – based skills and the other with highly specialized skills such as risk management.

After the Transition: Typical Buyer Satisfaction With Their OCIO Decision

There are two industry surveys that both indicate that asset owners who chose an OCIO are on balance, satisfied with their decision.

Chatham Partners (2013) surveyed OCIO users on their satisfaction with the service. Five criteria were considered – Investment performance, Risk management, Meeting goals, Client service, Reporting. On a scale of 1 - 7, client satisfaction was 4 (average) or better on each of the 5 criteria for between 96 and 98% of clients.

Another survey by SEI Investments (2014) found that of those using OCIO, 32% plan to increase outsourced assets in 2015, 52% will remain the same, 8% plan to reduce OCIO and 4% don't know.

Overall, satisfaction appears to be high for those who have chosen the OCIO route.

Continuing Responsibilities of the Board/ Committee Post Outsourcing

- Monitor OCIO monthly/quarterly – relative and absolute investment performance and strategy, OCIO investment process & people, adherence to investment policies, fee calculations, outsourcing additional assets (if less than 100% initially)
- Consider additional or replacement OCIOs
- Spending & liquidity policies
- Investment policy and objectives
- Investment policy evolution – e.g. consider active vs. passive, use of alternative assets, risk management, asset/liability modeling, investment themes
- Total fees and terms of agreements with service providers

! Discussion Point: Possible Decisions by NSHE Arising From Workshop

- Continue with status quo – Board of Regents, Investment & Facilities Committee, Internal Staff, Current investment consultant
- Build a robust internal investment capability
- Solicit proposals from qualified OCIO vendors (selection will be subject to Staff/Committee/Board approval as needed)

! Discussion Point: If OCIO Path is Selected, Possible Direction to Staff

- Prepare a draft RFP for review by the Committee by December 3
- Consider the following selection factors ___________________________

! Discussion Point: Selection Factors

If the decision is made to consider an OCIO, the Committee or the Board could suggest that certain selection factors be emphasized.

It may be helpful to review the selection factors used by other users of OCIO services. The following list is from an industry survey which summarized typical selection factors.

Chatham Partners (2013)

Investment Capabilities & Services

- Asset allocation expertise
- Multi – asset class coverage/expertise
- Demonstrable outperformance
- Alternative assets expertise
- Global assets expertise
- ALM expertise
- Product agnostic advisory team
- Open architecture
- LDI expertise

Firm Attributes & Service Models

- Reputation and financial stability of team
- Experience and seniority of staff
- Experience as an OCIO
- Client service model
- Operational and admin capabilities
- Fiduciary services
- Customized services
- Cost
- Regulatory and fiduciary education
- Current or past relationship
- Size of firm

! Discussion Point: Additional Selection Factors

- Size of OCIO firm/number of clients/fit
- Fees
- Demonstrable added value (track record)
- Endowment/Operating pool expertise
- Ability to customize
- Service levels
- Recognition and mitigation of conflicts of interest
- Operational strength
- Focus on investing over gathering assets
- Ancillary services

Today’s Takeaways