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Outsourced CIO Firms Gain Traction with Private Wealth Managers[1]

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Doug De Groote has carved out a pretty sweet life in California. The Founder of De Groote Financial Group, a five-employee registered investment adviser in Westlake Village, near Los Angeles, works from a terra-cotta-roofed villa shaded by palm trees. A few miles south is Malibu, the beachside town favored by Hollywood stars and sun-baked surfers.

That picturesque West Coast setting isn't the only reason De Groote counts himself lucky. Since late 2013 his $240 million RIA firm has been using an outsourced chief investment officer, or OCIO, to help serve its clients, most of whom are entrepreneurs and senior executives.

De Groote had been considering such a move for several years. "l just realized that I couldn't be all things to all people," he recalls. Research and due diligence on investments consumed much of his time, leaving less energy and resources to counsel existing clients and bring in new business.

So De Groote enlisted Dynasty Financial Partners, a New York—based wealth manager that today does third-party investment management for about 30 firms with combined assets of more than $20 billion. "l realized that the services they provided gave further insight into various asset classes than what I had time for," he says.

Dynasty handles research, offers access to high-quality investment products and keeps De Groote Financial Group on top of new regulations. Depending on the amount of assets under management, Dynasty charges fees ranging from 30 to 50 basis points.

For De Groote, whose typical client portfolio is about $1.2 million, it's money well spent. Since he hired Dynasty, his firm has seen a 30 percent growth in assets. "Over the years our partnership with Dynasty has really become a symbiotic one," he says.

De Groote's firm is one of many private wealth managers that have turned to OCIOs over the past decade. Long popular among institutional investors such as endowments and pension funds, the model is gaining traction with RIAs and family offices. OCIOs can help RIAs grow by letting them spend more time with clients and exposing them to a wider variety of investments. Family offices, for their part, don't always have the expertise or time to select and monitor managers across a broad swath of

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[1] Anne Szustek. "Outsourced CIO Firms Gain Traction with Private Wealth Managers." *Institutional Investor*, Institutional Investor, 21 Oct. 2016, www.institutionalinvestor.com/article/3594685/investors-registered-investment-advisers/outsourced-cio-firms-gain-traction-with-private-wealth-managers.html.

investments. But outsourcing isn't for everyone. Using an OCIO might undercut a firm's brand, and it may not provide enough flexibility in portfolio management.

RIAs have plenty of motivation for seeking help from an OCIO. For starters, managers at these firms are as much diplomats and therapists as they are investors. At one client meeting an RIA might have to referee an intergenerational squabble over family philanthropic pursuits; the next might involve counseling an entrepreneur in her 20s whose skills are more high-tech than financial.

The typical RIA has less than $320 million in assets, nine staff and between 26 and 100 clients, according to the Washington-based Investment Adviser Association. Clients' varying circumstances and goals call for a range of strategies that may require research into unfamiliar asset classes, from hedge funds to emerging markets equities. The need to find new and better sources of return has grown even more acute in a low-interest-rate world.

For a firm with a handful of employees, something has to give. Rather than spend days poring through prospectuses, why not engage an OCIO that understands such products — and is willing to shoulder the risk?

Like RIAs, wealthy families may find themselves juggling a bewildering set of investments from multiple providers. That problem prompted David Savir to cofound Element Pointe Advisors, a Miami-based OCIO specializing in private wealth clients, in March of this year. "We recognized that a lot of ultrahigh-net-worth families were working with several institutions at once, and there are a lot of challenges to doing that," says CEO Savir, who launched $123.6 million Element Pointe with fellow J.P. Morgan alumnus Carlos Dominguez. "It can be hard to control the overall portfolio," he adds. "Another is that you're not benefiting from economies of scale."

OCIOs offer other potential advantages. "An outsourced solution can also iron out family squabbles," says Philip Walton, president and head of the private client practice at investment consulting firm Cambridge Associates in Boston. If a third party manager rather than a designated family member is handling the wealth, relatives may feel freer to veto a portfolio decision, Walton explains.

Along the same lines, hiring a neutral party in a different location can make intergenerational wealth transfer less messy. "When there is a question of who in the next generation is going to oversee the investments, an outsourced solution can work well," Walton says.

The use of OCIOs by RIAs and family offices is part of a broader outsourcing trend. In a poll of financial advisers released last month by Chicago-based Northern Trust Asset Management, about 40 percent of the 680 respondents said they used external managers. RIAs, which made up 36 percent of survey participants, cited freeing up time in their practice, generation of above-market returns and access to investment strategies as their top three reasons for outsourcing.

Of respondents who had turned to outside asset management, 96 percent were happy with the arrangement. That number rose to 100 percent for firms with more than $3 billion in assets.

Besides revealing that most RIAs still manage their own money, the Northern Trust survey found that firms keeping investment management in-house were most likely to do so because it was central to their value proposition. For many RIAs, being small is a selling point; it means fewer clients and ostensibly more-personalized service. Clients who have built a decades-long relationship with an adviser may feel uneasy about entrusting their wealth to a faceless third party. And they might wonder why they're investing with a firm that pays someone else to manage the house.

Outsourcing lets wealth managers pass the buck for bad investments, critics charge. According to one financial adviser who works mostly with family offices, the main advantage of an OCIO is that it gives clients the option of saying: "l didn't buy that crappy hedge fund. Someone from asset manager X did."

What's more, detractors argue, paying an outsourced manager may not be any cheaper than hiring an in-house CIO. Once fees, usually a percentage of assets under management, are taken into account, an RIA or family office may be better off paying someone a salary and having them just down the hall. Respondents to the Northern Trust survey who opted not to use an outsourced investment manager cited fees as one of the top five reasons.

Still, demand for OCIOs appears to be strong. Since 2013 the number of U.S. providers has grown by about 25 percent, says Jeffrey Stakel, a principal with Casey Quirk by Deloitte, a Darien, Connecticut—based asset management consulting firm. In just the past year, the total has jumped from 50 firms to more than 70, he estimates.

"l think I'm seeing a lot more outsourcing because private investors are seeking institutional-quality concepts and wealth advisers want to step in to offer holistic solutions," Stake' says. Demand for more-sophisticated products means that firms and clients need more help, he adds. "The spate of outsourcing means at least two big trends: The OCIO market is maturing, and much attention will be paid to how to evaluate and select an outsourcing provider."

Jonathan Hirtle thinks the term "OCIO" has become a buzzword. "It's the latest thing," he notes. "Everybody wants to say they do it."

Hirtle, whom industry colleagues call the Oracle of Outsourcing, was early to the party. During the 1970s and much of the '80s, he worked at Goldman Sachs Group in Philadelphia as an adviser to families and institutional investors. Hirtle noticed that $100 million family portfolios weren't getting the same returns as their $1 billion-plus institutional counterparts. Economies of scale might have had something to do with it, he thought, seeing an opportunity to level the playing field. Hirtle also figured that CIOs at the big firms would have access to the most talented managers.

In 1988, with Goldman colleague Donald Callaghan, he founded Hirtle Callaghan & Co., a West Conshohocken, Pennsylvania—based firm that focuses solely on outsourced CIO services. Hirtle Callaghan asserts it was the first to label such an offering.

Today the roughly 100-employee manager runs portfolios for more than 150 families — typically with between $5 million and $500 million in assets — as well as endowments, pension funds, captive insurers and health care institutions. Private wealth accounts for about half of Hirtle Callaghan's $23 billion in assets.

"Our investors are astute," says executive chairman Hirtle, who stepped down as CEO in August in favor of Ranji Nagaswami (page 46). "They take advantage of our multibillion-dollar purchasing power to get a specialist to identify superior specialist managers.

The firm doesn't handle outsourcing from RIAs, and if Hirtle has any say, that's how things will remain. He cites quality control as a big factor. "We're idealistic," he says. "We want our clients to have an optimal experience, and that is more difficult when delivered via an adviser we don't necessarily know very well."

Hirtle Callaghan offers discretionary advice and gives clients a greater choice of asset classes than they would enjoy on their own, Hirtle says, often for less than they'd otherwise pay. The firm charges a flat fee that varies by assets under management; the minimum is 20 basis points, and a client with $100 million in assets would pay 35. "It's really taking the advantage that the very large institutions have and delivering it to smaller institutions," Hirtle explains.

A true OCIO takes responsibility for its clients' investments and keeps them informed, he adds: "We want to be able to talk directly to clients and make sure that they are getting our input both on risk and return, what are reasonable expectations and so forth."

By the time Hirtle Callaghan launched, OCIOs already existed, if not by that name. So-called open architecture firms, which combined products from several financial firms into a discretionary portfolio, were counseling in-house investment advisers at pension funds and endowments during the stock market and stagflation travails of the 1970s.

A well-known OCIO that got its start that decade is Wilton, Connecticut—based Commonfund, whose clients include educational institutions and other nonprofits. By the late '70s, Northern Trust and asset manager Russell Investments had launched dedicated fiduciary management services. Today other major OCIO players include BlackRock, Northern Trust Corp., State Street Corp. and human resources consulting firms Aon Hewitt and Mercer.

It wasn't until this century, though, that the OCIO model for private wealth started hitting its stride. The technology bust of the early 2000s, followed by the 2008—'09 financial crisis, made managers wary of going it alone. In a 2009 survey of single-family offices conducted by the Family Wealth Alliance, a Wheaton, Illinois—based firm that researches and consults on private wealth, four out of ten respondents had recruited outsourced CIOs for wealth management. For smaller family offices, defined as having $500 million or less in assets, the proportion swelled to two thirds.

Pension funds, endowments and foundations still account for the bulk of the outsourcing market. Between 2007 and 2015, outsourced assets under management for U.S.-based firms surged by 860 percent, according to San Francisco—based executive search firm Charles Skorina & Co.; as of this March they stood at $1.3 trillion.

Private wealth managers interested in working with an OCIO need to find one whose approach meshes with theirs — otherwise a firm risks watering down its brand. Those pondering whether to outsource should ask themselves two questions, says Jeffrey Levi, a principal at Casey Quirk: "What is required, and where is the family going?”

Using that as a starting point, the firm can figure out what asset classes or strategies might be a good fit for a client, even if it doesn't have the means to handle them. If necessary, the wealth manager can then consult with an OCIO to build a customized investment package for the client. Such an approach gives the OCIO the chance to develop something that could be a "really distinctive service," Levi says.

Some OCIOs might offer a fund that's otherwise out of reach for a smaller RIA; they could also give guidance on asset allocation. Generally, though, it's alternatives that get RIAs and family offices into the OCIO orbit. A five-person shop lacks the time and staff to do thorough due diligence on private equity deals or parse a hedge fund strategy. By contrast, OCIOs are more likely to have the research capacity and the assets to put a new investment idea into action.

Fees are another key consideration given that clients pay a certain amount to retain a wealth manager in the first place. Hiring an OCIO can cost as much as 100 basis points — though the rate is usually 30 to 80 basis points. Getting access to asset classes such as alternatives can be more expensive.

Some in the industry think that money would be better used elsewhere. "Compensation should be recognition of risk taken by the manager," says one New York—based adviser to family offices. " When you have straight-up advice with fees expressed as an amount of assets under management, that's not worthwhile."

Depending on the size of the family office or investment adviser, the solution is fixed-fee compensation, the adviser says. For one thing, it's cheaper to pay $500,000 in an annual salary for an in-house investment manager than upward of $1 million to an outsourced CIO. Given their relative obscurity, however, a family office or investment adviser might have a tougher time attracting star investment talent than a buy-side asset manager would.

An OCIO can help a small manager to deal with circumstances in which governance rights and responsibilities may not be readily apparent, says Cambridge Associates' Walton. These situations include offshore holdings and blind trusts; public officials use the latter to manage their business interests so they can avoid conflicts of interest.

Wealth managers have a duty to stay abreast of changing rules that affect their clients. By using an OCIO, family offices can comply with a sometimes problematic regulation. The Dodd—Frank Wall Street Reform and Consumer Protection Act of 2010 did away with an exemption that let so-called small advisers — those with fewer than 15 clients, a category that includes most family offices — avoid registering as investment advisers, but it gave the Securities and Exchange Commission the power to determine what constitutes a family office.

To make the grade, the office must be run and controlled by family clients and not position itself as a full-fledged adviser. How spouses and their in-laws — as well as any ex-spouses — fit into this definition is more ambiguous. If they are counted among the family office's clients, they may obligate the business to register with the SEC. An OCIO — which presumably already has its SEC bona fides — offers a ready work-around.

When it comes to investing, outsourced managers take a variety of approaches. Does an OCIO do its own portfolio outsourcing? "There is no single answer," consultant Levi says. For passive strategies an OCIO might opt for a third-party, low-fee product. If the strategy is large enough, however, an OCIO might run it inhouse using exchange-traded funds (ETFs).

The same goes for outsourcing an active strategy, Levi observes. Some OCIOs have the scale to manage it themselves, but others tap external providers. "As the OCIO space continues to grow, the portfolios they offer will vary even more," Levi says.

Another factor that influences how a portfolio gets managed is the amount of outsourced assets. The bigger the pool, the more opportunities there are for customization and hands-on fiduciary management by the client.

Starting at about $1 billion in assets, RIAs can tap into outsourced multiasset, multimanager offerings in which the wealth manager has a say in the strategies and asset allocation. The smallest firms may be limited to turnkey asset management programs (TAMPs), which are essentially OCIOs in a box. A firm can buy a TAMP to handle its entire asset management function, as well as back-office duties. On the flip side, TAMPs give users little or no say in asset allocation and manager selection.

Not being able to control the portfolio, especially with off-the-shelf packages like TAMPs, may dissuade some RIAs and family offices from considering outsourced services. Smaller players whose clients request specialized products such as environmental, social responsibility and corporate governance (ESG) investing, for example, may have a harder time finding a package that works.And firms of all levels may get pushback from clients on the extra fees assessed for outsourcing of services. Individuals using an RIA are already paying for that personal connection — how much more are they willing to fork out?

Scott Welch, chief investment officer of OCIO Dynasty Financial Partners, has his own take on why RIAs use OCIOs. Maybe tax or estate planning is an adviser's wheelhouse, Welch reckons, or perhaps they need to spend more time consoling clients who might not be financially savvy.

"Some clients see a market hiccup on the S&P 500 on their office elevator screen and go running to their adviser," he says. "They wonder, 'Why do I have all of this other stuff, such as alternatives?"' When a firm is more focused on the why than on the how, Welch explains, they come to Dynasty for help. He sees his role as keeping asset management running so his clients can keep their customers happy.

"We have clients who take pride in their traditional equities and fixed-income portfolios," Welch says. "When they want to diversify into, say, liquid alternatives, though, they know that's not an area of expertise." Even RIAs that do all portfolio construction in-house might turn to his firm to outsource portfolio management, thereby taking credit for the strategy. Dynasty also works as an external consultant with RIAs that prefer to manage everything in-house, stepping in when needed to provide guidance or a second opinion on compliance and regulatory matters. Near the top of that checklist right now, Welch says, is the U.S. Department of Labor's new fiduciary rule, set to take effect next April: "I haven't been to an investment conference in the past six months where that wasn't an issue."

The fiduciary rule might prompt even the most skeptical of wealth managers to consider working with an OCIO. The DOL regulation requires any firm or individual operating as a financial adviser to offer products that are in their clients' best interest. The OCIO model, whose 1970s roots owe much to the need for discretionary advice, dovetails with this new obligation.

It's too early to tell how much in assets is flowing to OCIOs because of the fiduciary rule, but private wealth managers appear to be waking up to the idea that they need help. Forty-seven percent of respondents to the recent Northern Trust survey on external asset management said they would be open to third-party support on how the fiduciary rule stands to affect their advisory business. About 40 percent expressed an interest in receiving training on the regulation's best-interest contract exemption, which allows brokers and advisers to offer commission-based products as long as they disclose the details of those offerings and their associated fees in writing.

One OCIO product that could prove useful with the advent of the fiduciary rule is the TAMP. For a fee that often comes out to a couple of dozen basis points, TAMPs offer not just an off-the-shelf OCIO service but also the opportunity to modernize a firm's financial technology platform. The top three providers, according to U.S. financial information company BrightScope: $162.3 billion SEI of Oaks, Pennsylvania; Chicago-based Envestnet, with $82.1 billion; and Concord, California —based AssetMark, with $20 billion.

The history of TAMPs has some regulatory parallels with the present. ERISA, the U.S. government's landmark 1974 pension legislation, brought the idea of fiduciary duty into the general investment consciousness; that change led to the rise of fee-only accounts such as TAMPs as an alternative to broker-dealers pushing their own products.

By 1986, TAMPs had hit a critical mass of $1 billion in assets under management and administration. Between 2011 and last year, the total climbed from less than $147 billion to $1.75 trillion, according to Tiburon Strategic Advisors, a financial services consulting firm based in the San Francisco Bay Area.

TAMPs are growing for the same reasons as the broader OCIO market: Besides allowing small investment firms to buy into institutional-quality products, they offer due diligence and risk controls, and handle back-office functions such as trade rebalancing. A wealth adviser could buy one of these packages, hang out a shingle and open for business.

Unlike OCIOs such as Hirtle Callaghan, TAMPs give clients the option to white-label their product. For a small firm whose calling card is personalized service, that can help with branding and marketing. Advisers have reported winning larger accounts after white-labeling, and Tiburon estimates that about 25 percent of wealth advisers are farming out at least some functions to TAMPs.

Not all firms are sold, though. "TAMPs are really where we see a split on advisers,' says Marie Dzanis, head of intermediary distribution at Northern Trust. Many of the ultrahigh-net-worth clients served by RIAs are likely to want a product that at least appears more sophisticated than the suite of ETFs that make up many U.S. employer-sponsored 401 (k)s.

Whether or not wealth managers like TAMPs, these products offer clues as to how they might scale their businesses tomorrow. Dzanis points out that for firms large and small, the 9-to-5 workday is gone. Demand for round-the-clock access to portfolio performance will only grow stronger: Rather than make a weekday appointment, clients prefer quickly checking in on their wealth manager between other tasks. Meanwhile, some clients, especially Millennials and younger Generation Xers, conduct all but the most formal conversations online.

Robo-advisers, many of which are essentially TAMP may offer RIAs a way to outsource the technical side of the business while putting younger clients at ease. "I like to call it investment privacy with a glass of wine," Dzanis says.*

But one obstacle for robo-advisers — and for OCIOs in general — is that the wealth management industry still thrives on human interaction. As former CEO of Wealthcare Capital Management, which has nearly $2 billion in managed assets on its proprietary Financeware platform, Michael Ashker was charged with recruiting RIA clients and integrating their practices with Wealthcare's software. Richmond, Virginia—based Wealthcare's software product serves as an outsourced CIO, offering services such as customized portfolio management and due diligence.

Although Ashker concedes that wealth advisers must be familiar with technology, he's not sure that robo-advisers are the answer. "Whether your approach to investing is adviser-driven or if you're a delegating type" — an RIA firm looking to outsource, for example — "at the end of the day, it's about being an adviser," he says. That means giving advice.

Like RIAs, traditional OCIOs face the question of how to handle client volume, Casey Quirk's Stakel says. By their nature, these firms are very difficult to scale, he adds. The level of customization needed to advise clients — especially a group as diverse as high-net-worth individuals and families — means that a large OCIO can't cater to everyone. That's where smaller firms come in.

Still, as clients crave new asset classes and investment strategies, more OCIOs are opening their doors to meet the subsequent demand for third-party consulting. Stakel expects a reckoning soon. "I see consolidation in the market," he says. "I don't know when we'll see the saturation point, though it's coming."For his part, wealth manager De Groote has no regrets about hitching his firm's wagon to an OCIO. "Dynasty has become part of who we are around here," he says.

"They're another set of eyes for us."