

## BUILDING BLOCKS AND COSTS OF AN INTERNAL INVESTMENT OFFICE

# Fiduciary Insights

**THIS EDITION OF OUR FIDUCIARY INSIGHTS SERIES CONSIDERS THE CORE FUNCTIONS AND COSTS OF AN INTERNAL INVESTMENT OFFICE FOR INSTITUTIONAL INVESTORS.** We believe that our analysis will be of interest as a comparator to insitutions that already have an internal investment office or are considering building one.

# Executive Summary

This paper considers the core functions and costs of operating an investment office for institutional investors. We focus on three illustrative cases analyzing what it takes to actively manage multi-asset class portfolios with \$500 million, \$2 billion, and \$10 billion in assets. Our analysis focuses on recurrent costs, ignoring the considerable direct and opportunity costs of setting up an investment office.

We base our analysis on publicly available information, our own experience, and market intelligence. During our three decades of serving as an OCIO, we have observed a variety of approaches to managing investment portfolios adopted by a wide range of institutional investors. Many of our staff have first-hand experience of different investment management models from the vantage of working in senior positions across the industry and on the investment teams of endowments and foundations. We have drawn on this breadth of experience to complement an analysis of the publicly available data with our own detailed, bottom-up cost estimates.

We recognize that the size and structure of investment offices vary widely depending on the level of assets under management, the complexity of the strategies being pursued, and the preferences and circumstances of the institution. Nevertheless, all actively managed investment offices must, in one way or another, perform certain core functions to fulfill their fiduciary responsibilities. Our analysis identifies broad tendencies in how institutions of varying sizes design and structure their investment offices. We draw the following conclusions from our research.

- As is true in general in the finance industry, there are significant economies of scale in portfolio management. Costs as a *percent of assets* tend to decline as the portfolio grows.

- However, the *absolute costs* of an investment office increase with size, reflecting the need for more staff and more sophisticated systems. Staff are by far the single largest cost item, representing between 75-85% of the total.
- As portfolios grow in size, the complexity of the investment strategies pursued tends to increase. The operational demands on the investment office go up correspondingly. Regulatory and compliance demands are significant. Moreover, institutions tend to undertake more and more operational functions in house. As a consequence, the proportion of operational staff in total staffing increases with size at an accelerating pace.
- The structure of the investment team also changes with size. In the case of smaller investment offices, the investment team tends to comprise mainly generalists. As the portfolio being managed grows in size and complexity, there is a tendency toward increased specialization with dedicated teams focusing on a particular asset class, or private versus public market investments.
- There are significant hidden costs that are often overlooked when institutions consider the relative merits of establishing an internal investment office. These are mainly ad hoc in nature, arising when there is significant staff or manager turnover or when external managers pose legal or compliance problems. These unforeseen, irregular, and intangible costs can be substantial. Moreover, there are significant initial start-up costs for those considering establishing an investment office for the first time.
- Building an internal investment office is but one of many models for managing assets. Each has its pros and cons.

We hope that our analysis helps frame the main factors that need to be considered when building an investment office. We recognize that others will have very different views. We welcome comments and suggestions and are available to answer questions on the assumptions underlying our estimates.

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# Introduction

This edition of our Fiduciary Insights series considers the core functions and costs of an internal investment office for institutional investors. We provide in particular a detailed breakdown of our estimates of the costs for institutions actively managing portfolios of \$500 million, \$2 billion, and \$10 billion. Our estimates are informed by publicly available information, industry sources, and our own experience. Our objective is to offer an indicative guide for institutions considering the establishment of an internal investment office. We believe that our discussion of core functions and their costs will be of interest as a comparator to institutions that already have an internal investment office in operation or are considering building one.

We recognize that there is a wide spectrum of investment office structures, and that each institution will have its distinct needs and preferences. Differences arise because of the size of assets under management, the nature of the operations being supported by the investments, the investment governance structure, and the preferred investment philosophy, approach, and objectives. Costs also vary widely by location and type of institution. Moreover, institutions have varying views on the appropriate scope of work undertaken in-house versus work better handled by third parties. These span a broad continuum from near total self-reliance to full outsourcing. There are nevertheless certain core capabilities required for effective portfolio management. Enumerating these core competencies and considering how and at what costs they can be fulfilled are the main objectives of this paper.

- First, we review the core functions of an investment office that in our view must be met to fulfill essential fiduciary responsibilities.
- Second, we discuss a range of cost estimates for the staff, systems, and other resources needed to undertake these core functions. We include in this section publicly available information on costs, which is scarce and hard to come by, as well as our own estimates based on first-hand industry experience.

- Third, we describe the intangible costs of maintaining an investment office.
- Fourth, we discuss the various models institutional investors use to manage their portfolios and the pros and cons of each.
- Finally, we conclude with a consideration of the key success factors for portfolio management.

## Functions of Internal Investment Office

Whatever its structure, size, or degree of reliance on third parties, an internal investment office must be equipped to perform certain indispensable functions and meet basic fiduciary requirements. We outline these core investment functions in Exhibit 1. As highlighted in Exhibit 1, the responsibilities of a fully resourced investment office span a wide range of investment, risk management, operational, and legal functions. In addition to the core functions summarized in the matrix below, there are important support services essential to the smooth operation of any institution. These include human resource management, as well as IT, office services, and related support staff.

## EXHIBIT 1: CORE RESPONSIBILITIES AND FUNCTIONS OF AN INVESTMENT OFFICE

Source: Strategic.

Area of Responsibility	Elements of Execution
Determination of investment objectives and risk tolerance	Analysis to frame a decision on investment objectives and risk parameters. Assess impact of different investment outcomes on the institution's finances and operations.
Investment policy design, determination of allowable asset classes, strategic asset allocation and allowable ranges	Research and analysis to design a strategic asset allocation (SAA). Develop capital market assumptions on the expected risk, return, and correlation characteristics of all investable assets. Design an SAA that is aligned with investment objectives and risk tolerance.
Manager selection, monitoring and termination and associated transitions	Identify promising active external managers across all asset classes. Continually scan the universe of active managers for promising new prospects and strategies. Monitor the performance and sources of return of existing managers to assess their continued fit with the portfolio. Maintain desired market exposure during manager transitions.
Portfolio Construction	Construct portfolios of active managers across each asset class that encompass a large number of independent sources of added value. Combine the asset class portfolios to construct a robust portfolio that is well diversified across market exposures and sources of active return.
Active asset allocation within and across asset classes	Monitor asset pricing across and within asset classes to identify pricing that diverges from fair value. Design and implement strategies to exploit significant divergences from fair value.
Risk Management	Develop models and surveillance techniques to monitor the sources of risk within each asset class. Measure risk at the total portfolio and asset class level. Minimize unremunerated risks, avoid concentrated positions, and eliminate undesired exposures.
Research	Monitor developments in financial theory, markets, and strategies. Develop new analytical tools to analyze markets, evaluate asset pricing, measure and manage risk, forecast cash flows, and assess the sources of return.
Manage portfolio liquidity and flows	Forecast cash flows related to capital calls, distributions, and flows needed to support operations or meet liabilities. Handle transactions to generate and transfer liquid funds. Model impact of large market movements on the ability to meet obligations and rebalance the portfolio.
Custody	Select a custodian for the safekeeping of assets. Negotiate scope and terms of custodial services.
Operational Due Diligence	Assess integrity of the internal controls, systems, asset valuation calculations, and compliance procedures used by external investment managers and the internal team.
Performance Reporting	Prepare reports on portfolio positioning and performance. Analyze the sources of value added. Assess compliance with investment guidelines and risk parameters.
Tax and Audit	Prepare financial statements and tax documents. Conduct internal audits.
Legal and Compliance	Negotiate terms with external service providers. Vet the legal and compliance controls of external service providers. Monitor regulatory compliance and make regulatory filings.

## Investment Functions

The investment office team has four core functions. It must determine, in close collaboration with the institution's senior management and Board, the right return target and risk parameters for the institution. Having identified these key objectives, it designs an asset allocation expected to deliver the target return within the acceptable risk bounds. The task then turns to implementation and the day-to-day management of the portfolio to achieve the desired tradeoff of risk and return. Finally, the investment team continuously evaluates the appropriateness of the objectives, asset allocation targets, and management techniques and recommends changes as appropriate (Exhibit 2).

Orchestrating this effort is the CIO (or office of the CIO) guiding the work of teams responsible for managing the asset class building blocks of the total portfolio. The CIO ensures that each building block plays its intended role, complements the other asset pools, and contributes to the total portfolio's objectives. In addition, the CIO leads the consideration of active asset allocation

decisions designed to exploit valuation anomalies across and within asset classes. The CIO also plays a critical risk monitoring role. He or she reviews, preferably on a daily basis, the underlying exposures of the portfolio to assess whether they are consistent with tactical targets, risk parameters, and investment guidelines.

The investment team is charged with identifying external investment managers expected to deliver strong risk-adjusted excess returns net of all fees while also complementing the other active investment managers included in the asset class portfolio. Depending on the size of the portfolio, the investment team can comprise mainly generalists or, as the portfolio increases in complexity, specialists focusing on particular asset classes or types of investments. In addition to hiring and firing external managers, the investment team, however it is structured, monitors the valuation of global asset market to identify exploitable pricing anomalies. In the case of larger portfolios, the investment team should also be equipped to trade index futures and ETFs to manage portfolio exposures. Specialized analytical tools and databases support this effort.

*Establishing risk and return objectives, designing optimal portfolios to achieve those objectives, actively managing portfolios, and continuously evaluating the strategy and its implementation are the four core functions of the investment office.*

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### EXHIBIT 2: CORE AND INVESTMENT FUNCTIONS

Source: Strategic .





The investment team is complemented by a research group charged with developing analytical tools to assist in asset valuation assessments, portfolio construction, risk management, trading, and performance analysis. The research group also monitors financial markets to identify new investment strategies and techniques, complementing the work of the investment team. In the case of smaller investment offices, consultants are used in varying degrees to support the research function. With increasing size, there is a tendency to bring more of the research function in-house.

## Risk Management

Risk management unit is an indispensable complement and check to the investment team. Although the due diligence work of the risk team in many ways parallels that of the investment team, it is essential that the risk team be organizationally distinct from the investment team to ensure that its judgments are arrived at independently. The risk team should review all major investment actions and have veto power on manager hiring as well as on changes in underlying exposures at the total portfolio and asset class levels. The risk team also requires specialized analytical tools and databases. Although essential, many smaller investment offices lack the capacity to staff an independent risk unit, relying instead on outside consultants for support in manager selection, portfolio construction, and risk monitoring.

## Operational Due Diligence

Operational due diligence is an essential component of risk management that in many cases does not receive sufficient attention. A thorough operational due diligence (ODD) review is needed to complement the work of the investment, legal, and risk teams in assessing new external investment managers. The ODD team focuses on the internal controls, compliance systems, and asset pricing procedures of all external investment managers. It assesses whether the operational practices and standards of external managers under consideration are consistent with best practice. The ODD team also has an important role to play in verifying that the institution's internal processes and controls are robust. ODD is another function

that is often outsourced by smaller investment offices. Even large institutions rely on specialist firms for background checks and related services.

## Reporting

The assessment of portfolio positioning and main drivers of portfolio returns provides an important disciplining function. By helping to identify which strategies worked and which did not, detailed portfolio reporting helps the investment team improve. Clear reports on portfolio positioning relative to guidelines and performance relative to expectations are key elements of investment governance and essential inputs into the decisions of senior management and governing bodies. The maintenance of proper accounting records is the basis for performance reporting as well as for the preparation of audits, regulatory filings, and financial statements. Custodians provide much of the raw material for performance reporting across investment offices of all sizes. Larger investment offices tend to supplement the custodian's data with internal reporting capabilities that serve as an integral part of performance monitoring.

## Operations

The operations function is responsible for executing all portfolio flows and monitors cash balances needed to execute planned transactions. These include flows to and from newly hired or fired managers, the direct trading of index futures and ETFs for exposure management and portfolio rebalancing, capital calls and distributions related to private equity and other investments, as well as contributions to and withdrawals from the investment pool. In addition, the operations team is responsible for ensuring the safe custody of assets by evaluating the terms and quality of services of custodians and monitoring their performance and the competitiveness of their fees. All investment offices rely to some degree on custodians and other third parties to help manage their operations. However, there is a clear trend for internal operational capabilities to grow with the size and complexity of the portfolio.

# Publicly Available Data on the Costs of an Internal Investment Office

## Tax and Audit

The preparation of financial statements, tax reporting, and coordinating the work of the external auditor are the chief tasks of the tax and audit group. While investment offices of all sizes rely on external services to satisfy tax and audit requirements, the internal time and resources needed to complete these tasks are often underestimated, especially when difficult to value assets are included in the portfolio.

## Legal and Compliance

The legal function negotiates the terms of agreements with third parties, assesses the legal controls of external investment managers, and ensures that the institution's operations and procedures meet regulatory requirements. The legal function assists in the due diligence of external investment managers, complementing the efforts of the investment and ODD teams. The legal and compliance function develops codes of conduct for the internal team and monitors their observance. It assists in the preparation of guidelines and governance procedures for investments. As with all functions, third parties play a role in fulfilling legal and compliance responsibilities. Nevertheless, internal legal resources are needed in virtually all cases and asset sizes.

Publicly available information on the costs of internal investment management is limited, making it difficult to define a cost benchmark. Such a benchmark is a potentially valuable tool to guide institutions in determining the appropriate cost structure of their internal team and compare the costs of alternative approaches, including total or partial outsourcing.

We have considered two different sources of cost estimates. The first relies on publicly available sources of information. The completeness of the cost information reported varies widely, with many institutions providing only a partial reckoning. In some cases, for example, the reported compensation of senior staff does not include bonuses. This makes it difficult to compare costs across reporting institutions and draw definitive conclusions from the data provided. Nevertheless, these data have the benefit of reflecting the direct experience of an albeit small set of institutional investors. We complement these publicly available sources on costs in the next section with our own estimate of the cost of a fully resourced investment office based on bottom-up estimates of the costs of each core function of an investment office.

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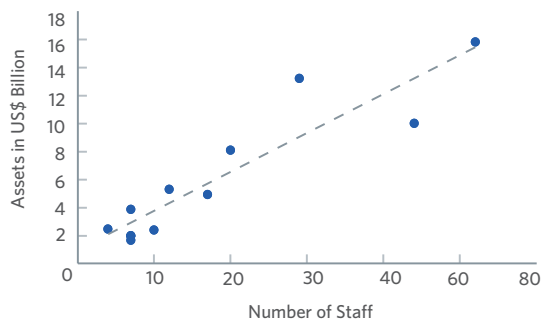
To compile the publicly available cost data, we analyzed Form 990s and the footnotes to the audited financial statements of dozens of organizations. While much of the data from these sources was unusable, it did yield some partial insights. The most reliable source of costs were filings from organizations with separate investment operating entities. Given their relative comprehensiveness and reliability, we have based our analysis on these data. Ultimately, we were able to find reliable cost data for only nine investment offices. These institutions had assets ranging from about \$2 billion to about \$10-15 billion. While an admittedly small and disparate sample, the data provide a picture of the costs and organizational structure that appeared consistent with our own estimates and market intelligence.

We draw several tentative conclusions from our analysis of the publicly available data.

- There are clear economies of scale. While costs tend to rise with the level of assets, the cost per dollar declines as assets grow. The institutions reviewed with assets of around \$2-5 billion have average reported costs of about 30 basis points, while those with assets of \$10-15 billion report costs of about 20 basis points.<sup>1</sup>
- Institutions take widely divergent approaches to structuring the size and capabilities of their investment offices. Despite these differences, there is a clear tendency for the level of staffing to increase with assets (Exhibit 3).
- Moreover, as the level of assets increases, the proportion of operational staff in the total increases, and the pace of this increase appears to accelerate with size (Exhibit 4). Institutions with a lower level of assets typically have relatively few, mainly investment staff. However, as the level of assets increases, the sophistication and range of investment strategies and complexity of portfolio management operations increase. As a result, more operational resources are needed and there is a tendency to handle more of the operational aspects of asset management in-house.
- Smaller institutions in our sample tend to rely more heavily on outsiders for essential services. This reliance takes two forms: third party vendors such as consultants, law firms, and software firms on the one hand, and the resources of the institution on the other. In the latter case for example, the investment office might rely on the staff and resources from the institution's accounting, human resources, IT, and legal departments.

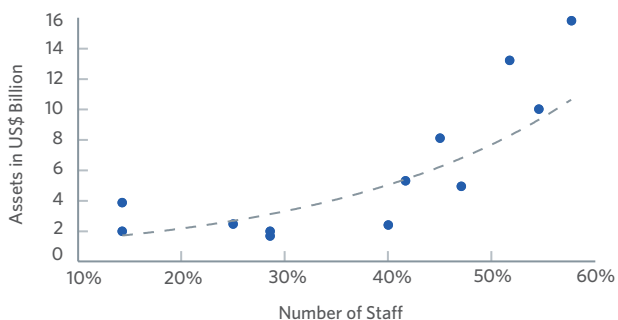
### EXHIBIT 3: STAFFING GROWS WITH AUM

Source: Strategic estimates and calculations.



### EXHIBIT 4: OPS STAFFING GROWTH ACCELERATES

Source: Strategic estimates and calculations.



<sup>1</sup>This result is not surprising. The large economies of scale of the financial industry are well known. Indeed, these savings are one reason why some institutions consider the OCIO model.



*We have developed three sets of cost estimates, one assuming assets of \$500 million, one with assets of \$2 billion, and a third with assets of \$10 billion. We have derived our estimates from direct experience, consulting with peers, and publicly available information.*

- The publicly available data provide an incomplete accounting of costs and thus have a downward bias. Services from third party vendors as well as those provided by other departments of the institution are not typically captured in the publicly available data on costs reported to be directly attributed to the investment office.
- By their nature, the publicly available data also omit ad hoc costs that arise periodically. These include the costs associated with the recruitment and training of new staff when there is staff turnover as well as the costs of adopting new software. This omission adds to the downward bias in the publicly reported cost data.
- In each case, we focused mainly on internal costs. Our estimates do not include, for example, custody costs or the fees of external asset managers. We assume that these costs would be incurred whether or not the institution built an in-house investment office or relied on an OCIO.
- We have also excluded the cost of office space, even though that cost can be substantial. We omitted these costs for two reasons. First, they vary widely across regions. Moreover, in many cases, the investment office is housed within the institution and that cost is not directly attributable to the investment office.
- We have assumed that in all cases, the institution relies to a greater or lesser extent on external third parties for investment consultancy services, legal counsel, operational due diligence, software and IT support, and custody and related services. In the case of the \$500 million portfolio, for example, the skeletal internal staff is assumed to be supported by a consultant for such functions as strategic asset allocation, portfolio risk management, all elements of investment and operational due diligence associated with hiring and firing external asset managers, as well as portfolio performance measurement. As assets increase, the support from outside sources decreases.
- We have assumed that internal trading is infrequent and limited to ETFs and executed through the custodian in the case of the \$500 million portfolio. In the case of larger portfolios, the extent and sophistication of trading increases. A sophisticated trading operation entailing more frequent trading and the use of futures would incur additional back-office costs and systems to manage margin and trading flows.

## Strategic Estimates of Internal Investment Office Costs

Given the deficiencies of the publicly available cost data, we have worked from the bottom up to develop cost estimates based on the individual costs of the main building blocks of a fully resourced investment office. A bottom-up approach resolves the problem of definition and comprehensiveness of the publicly available data while making it possible to customize cost estimates and specify how costs are defined.

We have developed three sets of cost estimates, one assuming assets of \$500 million, one with assets of \$2 billion, and a third with assets of \$10 billion. We have derived our estimates from direct experience, consulting with peers, and publicly available information. We were intentionally conservative in our estimates but believe that these estimates provide a good indication of the main recurrent costs to expect in operating an internal investment office. We made a number of simplifying assumptions.

- We assume that a \$500 million portfolio will have a small number of internal staff and that they will be focused mainly on investments. At this size portfolio, the investment office team uses consultants and the custodian for manager selection, investment and operational due diligence, risk and compliance monitoring, and performance measurement (Exhibit 5). In addition, the internal staff will also require outside legal counsel as well as IT, data management, and software support.
- With a portfolio of \$2 billion, the investment office is assumed to be larger and more self-reliant (Exhibit 6). The team would take on more of the responsibility for investment and operational due diligence, risk management, and performance measurement. The staff team's responsibilities are also assumed to expand to include some aspects of operations. Moreover, the portfolio is likely to be more complex to manage. This will entail more sophisticated systems and a deeper staff team. There will likely be continued recourse to third party service providers for operational due diligence, legal counsel, and IT, software, and data management support.

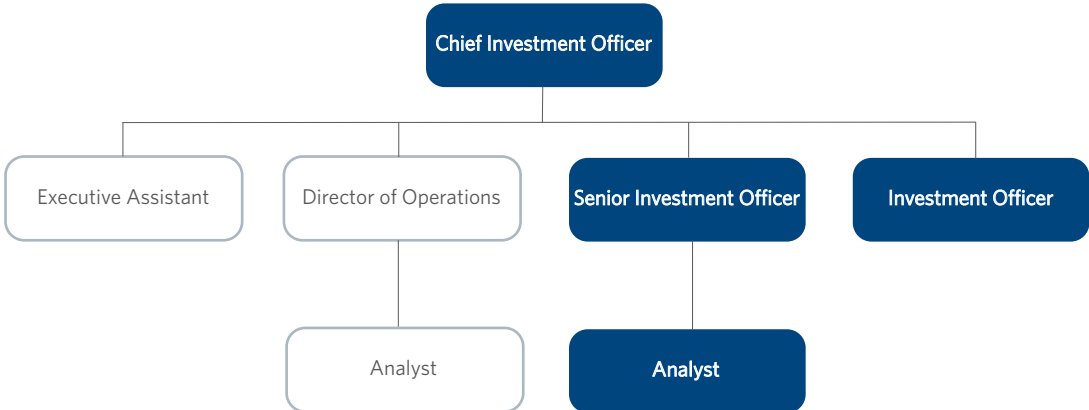
**EXHIBIT 5: STAFF STRUCTURE - \$500 MILLION PORTFOLIO**

Source: Strategic.



**EXHIBIT 6: STAFF STRUCTURE - \$2 BILLION PORTFOLIO**

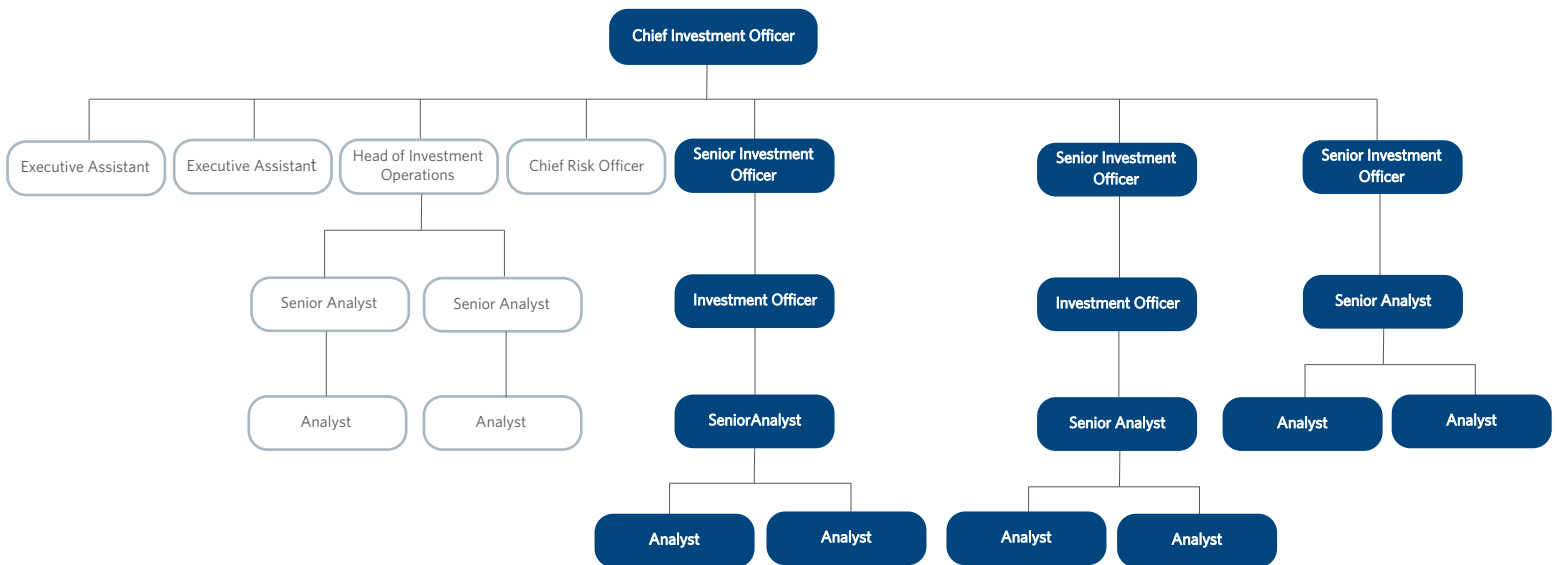
Source: Strategic.



- With a portfolio of \$10 billion, we assume that the internal team will be large and much less reliant on consultants and other external service providers (Exhibit 7). In addition to a deep investment team, it will also have a large operational team to handle the flows associated with a much more complex portfolio. More of the legal, auditing, operational due diligence and IT functions will also be resourced internally.

**EXHIBIT 7: STAFF STRUCTURE - \$10 BILLION PORTFOLIO**

Source: Strategic.



The table on page 11 provides a high-level breakdown of our cost estimates (Exhibit 8). We were deliberately conservative in our estimates considering the wide range of possible approaches. In all cases, we include the costs of the internal team as well as the third parties providing investment consultant services, IT support, operational due diligence support, and legal counsel. As noted, we explicitly exclude basic custody fees and the cost of office space, although we do estimate the additional fees charged by custodians for reporting and other services beyond basic custody.

Our estimates are similar to the average costs that we reported earlier using publicly available information. Our data also confirm that there are significant economies of scale to managing portfolios. Based on our conservative estimates, we find that a fully resourced investment office with \$10 billion in assets would cost about 12 basis points per year. A smaller investment office responsible

for stewarding a portfolio of \$2 billion would incur internal costs of about 24 basis points. An investment office managing a \$500 million portfolio would cost about 37 basis points, despite the relatively small size of the internal team.

In each case, staffing is by far the single largest expense, representing between 75-85% of the total. These costs will vary depending on salary scale, the degree of sophistication of each element of the portfolio management process, and different preferences for staffing numbers and levels. The costs of systems and software also vary widely depending on the provider, the system's capabilities, the degree of customization required, and the level of service needed. Despite these and other sources of variation, we believe that our estimates, coupled with the publicly available data reported in the previous section provide a representative indication of the costs that should be expected for each sized portfolio.

**EXHIBIT 8: INVESTMENT OFFICE COSTS**

Source: Strategic estimates and calculations as of February, 2024.

Costs	\$10B	\$2B	\$500MM
Staffing and Compensation	\$10,833	\$3,728	\$1,392
Hardware, Office Supplies	\$34	\$12	\$8
Internal Systems & Data Licenses	\$755	\$685	\$200
Manager Diligence, Monitoring Costs	\$777	\$397	\$250
Other Costs	\$48	\$4	\$4
Total Costs	\$12,466	\$4,825	\$1,854
Total Costs in basis points	12.0	24.0	37.0

# Unforeseen and Intangible Expenses

The quantified cost estimates assume a steady state of relatively trouble-free portfolio management. Experience suggests that this rosy scenario is rarely the norm. We believe that it would be prudent to build in redundancies to cope with costs arising from unforeseen contingencies and intangible expenses.

Such costs might arise because of the departure of key personnel, resulting in a loss of institutional memory. Recruiting and bringing key personnel up to speed takes time and energy and is often disruptive. In addition to these direct costs, there are potential opportunity costs associated with missed investments due to the absence of senior staff in key positions.

Higher than expected manager turnover would also entail direct expenses and potential opportunity costs. Disputes with managers would result in additional internal work pressures and outside legal expenses, especially in the case of difficulties with private market investments involving complex limited partnership vehicles.

Changes in key software and systems take time and effort as well as additional direct expenses and opportunity costs. Such systems almost invariably over-promise and under-deliver. Efforts to replace or upgrade them are also almost always late and over budget. Building such systems in-house is rarely cost effective, but relying on outside vendors can limit customization.

Location also matters and creates challenging tradeoffs. Cities with large financial sectors tend to attract the best talent and facilitate staff recruitment and retention. They also tend to have better access to a broader range of external investment managers and others providing investment-related services. However, the salary scale and other costs associated with operating in large financial centers is high. With staffing costs representing 75-85% of total costs, operating in an expensive financial center would add significantly to the costs of running an investment office.

*Unforeseen and intangible expenses from manager or staff turnover and the adoption of new systems can be substantial.*

# Internal Investment Management, Hybrid Models, and Outsourced Investment Office

Perhaps the primary fundamental question to be addressed is whether an internal investment office is the best option and, if so, where to strike the balance between reliance on internal staff and resources and external service providers. Endowments, foundations, and other large institutional investors follow three broad approaches: fully resourced internal investment office, a hybrid of internal staff and external services providers, and full outsourcing using an OCIO (outsourced chief investment office).

## Pros and Cons of the Internal Investment Office Model

Many large institutions build and maintain a fully resourced internal investment office capable of independently undertaking all of the core functions of an investment office. Self-sufficiency, independence, and exclusivity are often major motivations for adopting this approach. The desire for, and ability to achieve, self-sufficiency increases with asset size. However, all institutions, no matter what their size, inevitably resort to external service providers for some elements of portfolio management. Notably, most internal investment offices do not actively trade stocks and bonds, relying instead on active managers across these public asset classes as well as private markets. Many of even the largest internal teams also seek the advice of consultants and advisors. In some cases, custodians provide these institutions with services that go beyond the safeguarding of assets.

The internal investment office approach has the benefit of having all of the functionality of an investment office readily available, without the intermediation of a third party, thus enhancing the ability to respond quickly to seize investment opportunities and sidestep risks. This model also focuses investment discretion and accountability internally, thus removing any ambiguity over the responsibility for investment outcomes. While the use of external active investment managers does entail delegation to third parties, the internal team takes the lead in selecting these managers and determining their tenure. The institution's senior management and governing bodies have a transparent view into how the portfolio is being managed by the internal team. A fully resourced internal office also greatly reduces the potential for conflicts of interest to arise.

However, building a fully resourced investment office internally is a difficult and costly task, especially when the core function of the institution is not related to finance and investment. Recruiting and retaining a talented investment team is costly and challenging in the best of circumstances. These challenges are compounded if the institution does not offer a career development path to its investment team, faces budgetary and other constraints on its ability to offer competitive salaries, or is located far from a major financial center.

There are also potential opportunity costs of the internal approach. In particular, limited size and the lack of established relationships can hinder access to managers. Many top managers are closed to new funds, or open to additional investments only to established clients. A new team managing a relatively small pool of assets may have difficulty building the relationships and reputation to build a portfolio of top-tier managers. Finally, identifying, recruiting, and retaining top investment talent is challenging for all institutions, no matter what their size. This increases the risk that the internal team's returns fall short, resulting in significant underperformance, thus incurring potentially high opportunity costs.



## Pros and Cons of the Hybrid Approach

The vast majority of institutional investors adopt a hybrid approach that couples a small internal team with several external service providers, including external investment managers, and consultants who play a major role in identifying, vetting, recommending, and monitoring the performance of these managers. The balance between internal and external resources varies widely across institutions using a hybrid approach. In most cases, the internal team is limited to a few staff, many of whom have multiple responsibilities. Often, investment tasks are not their first or most important job. This necessitates recourse to external service providers to undertake and advise upon key decisions related to the core functions of portfolio management.

The hybrid approach has the benefit of adapting the size and capacities of the internal investment team to the institution's overall size. Using this approach, the institution avoids the cost and complications of building and maintaining the infrastructure of staff, systems and software needed to handle the investment and operational demands of managing a diversified portfolio.

The hybrid approach has important shortcomings. Outsourcing key functions to a number of different external service providers results in fragmented decision making and reduced efficiency. This model has all of the usual agency problems and potential for conflicts of interest inherent to a delegation of responsibility. Coordinating the various external service providers becomes a major preoccupation of the internal investment team. Accountability is diluted across many actors. Senior management and governing bodies have a less transparent insight into the portfolio management process. Their ability to exercise effective oversight is reduced. Finally, smaller institutions pursuing the hybrid model can have difficulty gaining access to the best external investment managers. Minimum investment size requirements often hinder the ability of smaller institutions to build a diversified portfolio of active managers in each asset

class. Small size is likely to hinder access to top-tier managers, increasing the risk of incurring opportunity costs arising from underperformance.

## Pros and Cons of OCIO

The OCIO model provides a fully resourced external investment office that acts as an extension of internal staff, management, and Investment Committee. The OCIO serves as a co-fiduciary and takes direct responsibility for investment strategy design, implementation, and performance. OCIOs provide all of the investment, operational, legal, and reporting functions of a fully resourced investment office. They offer institutions a one-stop shop for portfolio management.

The OCIO model has the benefit of eliminating the complexity and cost of recruiting and retaining an internal team. With the advantage of scale, OCIO solutions can be less costly than internal investment office and hybrid models. The OCIO model eliminates the fragmentation across service providers common with the hybrid approach. It is also more transparent and better integrated, thus offering senior management and governing bodies clear visibility into the management of the portfolio and a clear line of accountability. The buck stops with the OCIO. Because of the comprehensive nature of the services provided, investment decisions are executed more efficiently and nimbly than the hybrid approach.

In addition, an established OCIO with a long track record of successful portfolio management has the benefit of having developed relationships and established its reputation with top investment managers. This promotes access to top managers and innovative strategies thus facilitating the task of constructing portfolios with the potential to outperform the broad market. Moreover, an OCIO with critical mass is better able to negotiate fee breaks, special terms, and customized investment solutions with investment managers.

*Perhaps the primary fundamental question to be addressed is whether an internal investment office is the best option and, if so, where to strike the balance between reliance on internal staff and resources and external service providers.*

On the downside, the quality of OCIOs is mixed. Some OCIOs have multiple business lines creating inherent conflicts of interest. This lack of alignment typically translates into hidden and higher costs, artificial limits on the quality and range of investment strategies offered, and subpar performance. Given this range of quality and alignment, it is essential to choose wisely.

## Essential Ingredient for Success

*The ultimate key to building a successful investment office is to foster a culture that promotes integrity, collaboration, a spirit of inquiry and innovation, and the courage, discipline, and analytical rigor needed to shun the fads and bandwagons that so often lead investors astray.*

This paper has focused on dollars and cents and aimed to quantify what it takes to create a fully resourced investment office. A well-funded budget covering all of the main elements of portfolio management described in this paper is just a start. Each element must be marshaled to work together smoothly. This requires the cohesion of a collaborative culture that unifies each element of portfolio management. In addition to this unifying role, this culture must also foster a spirit of inquiry and innovation that over time deepens the analytical rigor and sharpens the judgement of the team. It must also foster the courage discipline, and analytical rigor to shun the fads and bandwagons that so often lead investors astray. Without such a culture, there is little chance of sustaining the returns needed to support the institution's mission. The secret to creating that culture is priceless.

# Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., venture capital/private equity, real estate, and/or hedge funds) or international investments, or manage strategies with high potential for adding value. Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

For more information, please email us at [inquiries@strategicgroup.com](mailto:inquiries@strategicgroup.com).

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