Why OCIO is now the answer more than ever

Aon's William Parry explores why using an OCIO approach can help trustees achieve their investment goals

OCIO or 'Outsourced Chief Investment Officer' is not a new concept. What is new is the expected market volatility in the new interest rate environment and the pain trustees went through in 2022 as we transitioned to this new environment. Some schemes were set up to tackle it smoothly, but many were not.

Economists are talking about the golden decade of investing now being behind us, caused by the prior low interest rate environment. This next decade could be much trickier – ensuring you have flexibility and speed in your decision-making framework will be crucial to taking advantage of market movements.

Additionally, increased volatility in interest rates is likely to lead to your circumstances and funding level changing more frequently. This means it is now critical to ensure your portfolio can cope with movements in your liabilities by building your framework with a partner who has a lens on assets and liabilities.

What is OCIO?

Put simply, OCIO allows certain investment-related tasks to be delegated by trustees and sponsors, allowing them to focus their time on their priorities. And by virtue of each set of trustees having different priorities, OCIO, at its heart, is flexible and bespoke.

Looking at all aspects of an investment idea, it goes from the initial consideration of where something fits in the broad strategy, all the way through size of allocation and specifics to transferring the cash.

Depending upon their expertise, trustees choose to outsource different parts of this process. The key question is at what point in the decision-making process the responsibility is passed across to the OCIO.

Passing some of this across is the bit that is consistent. Which is no great surprise because what I am hearing time and again, is that trustees want to retain different levels of the investment decision making. No-one is saying they wished they could sign more forms!

Isn't OCIO the same as fiduciary?

The term OCIO is occasionally used interchangeably with the term fiduciary management. They are both loosely defined but fiduciary involves passing across all decision-making, except for the high-level strategic goals, and is often more suitable for small to mid-sized schemes.

OCIO covers a range of models, including using multiple advisors, and tends to be for schemes looking at more bespoke solutions.

The reality of investing in the new higher interest rate environment, means more schemes are wanting to outsource their operational burden, but retaining some of the investment responsibility which can often be delegated in a typical fiduciary arrangement.

A multi-year journey in 12 months – why OCIO is needed more than ever
2022 was a remarkable year; a year which triggered many trustees and sponsors to review how they get from investment idea to getting the cash in the right place.

Equity markets replaced years of double-digit gains with huge downswings. Inflation went from bad to worse as it became stickier. Falling gilt prices throughout the year culminated in a loss of faith so extreme that investors rushed to sell UK government bonds hand over fist, triggering an effective run on their value.

Once the market settled down in Q4 2022, nearly every pension scheme had completed what would have been expected to be a multi-year journey. There were a wide range of outcomes.

But whatever the outcome, anyone who did not have complete operational support found an unprecedented level of time and effort was required even before September. Regardless of whether the scheme was in a better place, the whirlwind nature of the progression was unpleasant.

The value of OCIO – flexible and customised support
As a result of the turmoil, trustees have never needed (or wanted!) support more. We are now seeing many schemes wanting to have conversations around how their decision-making framework supports their circumstances. For more than a decade, fiduciary management has provided the answer to some of these questions, but more trustees and sponsors wanting help has led to demand for greater flexibility to fit into their decision-making framework.

In particular, trustees and sponsors of larger schemes who had previously considered themselves well resourced, have decided that they can keep some of the investment decision-making and separate this from the investment operations. Coming back to the point at the start, no one wants to sign any more paperwork!

This has driven the requirement for a more varied way of OCIO. The increase in schemes requiring OCIO has underlined how vital it is to consider the plan from the perspective of the total scheme, both assets and liabilities, when having these conversations. This is too big an issue to be solved by looking simply at one area of investment. A major part of designing the right solution is knowing how to structure the outsourced operations to keep doors open as opposed to closing off potential avenues.

Alongside understanding the drivers for the style of operational support, it is important to align to a business that can bring the right strategic understanding along with an established asset management expertise. A crucial aspect of a successful OCIO partnership is flexibility, allowing for complementary aspects of strategic insight and asset management robustness.

In short, OCIO is not a one size-fits all solution – trustees receive their own uniquely tailored solution based upon their goals, circumstances, values and beliefs. Ultimately, we believe this improves the likelihood of a scheme achieving its goals.

Using OCIO to stay sharp in investment
As schemes navigate a new environment, we expect OCIO models to further support trustees across key areas:

Rethinking Liability-driven investment (LDI) – After an extremely active year, LDI managers are working hard to complete robust stress testing and improve the resilience of LDI arrangements. It has reaffirmed the robustness of bespoke pooled structures and the appeal of tailored segregated accounts.

Cashflow-driven investment (CDI) – Many schemes have found their funding level progressions have outstripped their endgame preparations. Vastly de-risked portfolios are now likely to run for longer before deciding between self-sufficiency and other options (such as passing across to an insurer). The incorporation of CDI is being rethought, reflecting the higher interest rate environment and certain unexpected aspects such as the liquidity of CDI strategies (or otherwise) when put to the test last year. Modelling the liquidity of your exposure is as important as the cashflow-matching characteristics, all underpinned by a requirement that the investment makes sense from a combined assets and liabilities perspective.

Exploring new areas in growth – While specific areas such as LDI and CDI have gone through transformational shifts, the drive for innovation in growth portfolios is as strong as ever. For instance, looking at how companies will structure their carbon credits (noting nearly all companies are expected to need them). Or how schemes are tackling illiquids in their portfolios and considering immediate secondary markets sales or modelling running these off and the impact this would have.

The only constant is change
OCIO continues to be a more differentiated service. This next decade is expected to be very different to the last one and finding the right partner for the next stage of your journey will have a significant impact on your ability to continue moving forwards. A flexible OCIO structure built with your assets and liabilities in mind will help you ensure consistent progress.

As schemes look to learn how to navigate new forms of volatility, the one thing we can be sure of is that the only constant is change.

Written by Aon associate partner, William Parry

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