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# Pension plan OCIO—Is it right for your company?

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- Many defined benefit pension plan sponsors are considering using an outsourced chief investment officer (OCIO) to manage their pension plans. Using an OCIO has become a clear alternative to building and maintaining an in-house team or hiring a consultant to assist an internal committee.

- The interest in an OCIO stems from the need for specialized knowledge to properly manage pension investments. Pension investing differs from many total-return strategies adopted by other pools of institutional assets because of the specialized regulations and fiduciary considerations, and the outcomes can materially impact corporate financial results. Strategies such as glide paths and liability hedging require careful preparation and execution.

- It should not be surprising that from 2015 to 2019, the global OCIO market nearly doubled, from $1.3 trillion assets under management to more than $2.3 trillion, with defined benefit pension plans representing the largest share of the OCIO market (*Pensions & Investments,* 2020, and Cerulli, 2020).

- This paper reviews the primary challenges a plan sponsor faces when managing pension investments and outlines the factors to consider in meeting objectives. It examines three models for managing the portfolio: the internal team, assistance from a consultant, and the OCIO. With the help of a questionnaire, readers can better understand which model may be best for their unique pension needs.

The plan sponsor's decision about how to manage its pension investment portfolio can have important implications for key areas, including earnings, balance sheet results, corporate cash flow, and personnel. Further, a host of fiduciary requirements, decisions about the plan, and regulations, in addition to corporate actions, can influence portfolio design. These legal responsibilities can be daunting and require ongoing oversight.

The asset management approach for a traditional pension plan differs dramatically from the total-return investing approach often adopted by individuals or other institutional investors, which many consider a "normal" approach to portfolio construction. A plan sponsor must fully understand how the plan liability affects the investment process. In addition, given the changing risk-return trade-offs relative to plan status and funded ratio, important aspects of the strategy such as glide-path construction, liability hedging, and other risk-mitigation techniques require regular, ongoing attention.

Specialized expertise, either from an internal or an external provider, is needed to effectively run the asset portfolio, control risk, and make various pension plan decisions. This paper explains those risks and offers an approach to help you decide if your company might benefit from an OCIO service. Picking the right approach matters.

## Managing a pension plan: The requirements

### Fiduciary duty

Managing a pension plan requires specialized knowledge of its structure and of the unique regulatory and financial reporting frameworks for pensions. Mastering this knowledge is necessary to design an appropriate investment strategy.

Every plan sponsor should have access to this specialized knowledge, both to optimize plan outcomes and to comply with the prudence duty outlined in the fiduciary standards for qualified retirement plans mandated by the Employee Retirement Income Security Act, or ERISA.

According to the U.S. Department of Labor, "The duty to act prudently is one of a fiduciary's central responsibilities under ERISA. It requires expertise in a variety of areas, such as investments" (U.S. Department of Labor, 2017). Accordingly, a plan sponsor should reflect on whether its internal team grasps these concepts well enough to handle them effectively.

### Regulatory framework

Since ERISA was introduced in 1974, it has inspired a parade of rules and regulations that require understanding, interpretation, and implementation. This regulatory framework affects all aspects of plan operations, including plan design, administration, actuarial valuation, investment policy, and, ultimately, risk transfer and plan termination. Not every aspect of the corporate pension regulatory framework will affect investment strategy. Some, however—including financial accounting and minimum funding standards, Pension Benefit Guaranty Corporation (PBGC) premium requirements, and lump-sum minimum value regulations—are critical for those managing a pension plan's investments to understand.

## Company impact

A defined benefit pension plan is essentially a company's IOU to employees for when they retire. The pension plan sponsor must guarantee the employee IOU while accepting the market risk of the pension asset portfolio relative to the pension liability, which is valued using fluctuating market interest rates. As the pension liability can be highly sensitive to interest rates, these fluctuations can lead to a rising (or falling) liability value. At the same time, the pension asset value will be changing too. Consider a recessionary scenario: Falling rates will increase the pension liability value, while a sagging stock market may reduce the value of the portfolio. Given that both conditions generally reduce pension funding levels, employer contributions may be required during a period of economic stress when the company can least afford it.

The pension plan's potential impact on the plan sponsor depends on a lengthy list of variables that include the size of the plan, company cyclicality, the liability profile, pension plan benefit formula, plan growth rate, and portfolio design. The plan sponsor needs to determine its sensitivity to fluctuations in its plan's funding status.

If its sensitivity is low, i.e., if the plan has a small potential impact on the company's financial health, then the sponsor has a fair amount of flexibility in managing the plan. The plan sponsor can choose between having the plan assets do most of the work in improving/maintaining funding status or, instead, implementing a meaningful contribution policy along with a conservative asset mix. That choice becomes a matter of preference as opposed to necessity. If the plan's sensitivity is moderate or large, however, then determining how to manage the pension portfolio becomes more important. If you are responsible for a plan, you should ensure that your management team possesses specialized pension expertise. Whether that expertise comes from internal or external sources, they must be prepared for potential hurdles related to investment committee dynamics and personnel incentives, in addition to the challenge of identifying the appropriate pension investment strategy.

## Managing a pension plan: The requirements

### Committee dynamics

As previously mentioned, having the right people with the right specialized knowledge is critically important. But bringing together a team to take investment actions can be a challenge given the ways that many groups approach decision-making. One section of a Vanguard research paper on best practices for investment committees (Bosse, Grim, and Chism, 2017) includes a discussion on group dynamics. Here are just three problem dynamics:

**Herding:** The tendency to do what others are doing. Peer-group studies (e.g., Baddeley, 2010)—for instance, on asset allocation—often lead committees to stay near the peer averages even if their plan's characteristics, objectives, and optimal investment strategy may not resemble the group average.

**Overconfidence:** A belief in one's ability to prognosticate. Countless studies have demonstrated that even financial professionals have difficulty implementing an approach based in large part on market timing. And yet, committees often believe they can predict the future and will alter their strategic decisions based on their views.[1] As an example, interest rates are notoriously difficult to forecast and have an outsized impact on a pension plan—but that doesn't stop many committees from trying to predict rates.

**Group polarization:** When members of a group strongly agree on a certain topic, they often are willing to take a stronger or bigger position than any individual member would, leading the group to take larger portfolio risks than anyone intends.

An OCIO, with a deep team and experience in these matters, may be better equipped to avoid these issues, especially in times of stress.

### Personnel challenges: Career aspirations

This section may bring a grim smile to readers: Most company professionals with a pension oversight role are not volunteers. It is part of their job description, and often not a high-profile part. Managing the pension plan well is unlikely to land them a big promotion because it isn't perceived as being as important as their primary task. So, for these professionals, embarking on an education mission to internalize all pension investing knowledge can be a low priority. And it's not just those with the oversight role—other committee members may feel the same way (although there are a few of us who like this stuff). Especially as plans are closed or frozen, defined benefit pension plans may get pushed to the side.

1 See Goyal, Wahal, and Yavuz (2021) for more information on the hiring and termination of investment managers.

## Investment strategy

Pension investing is quite different from investing as it is taught in school. Normally, we view low-risk assets as those with low volatility, such as cash. In exchange for low volatility, we expect little compensation. On the other hand, to take greater risk, investors demand more return.

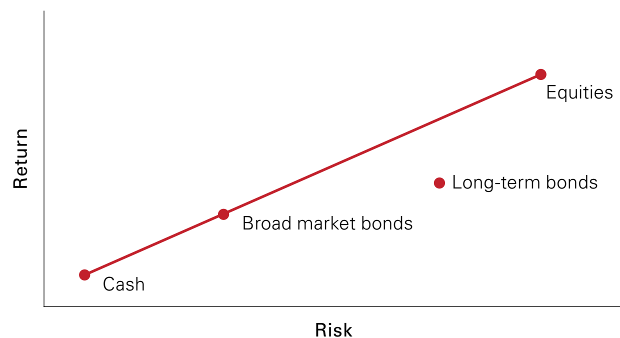
Equities are a good example. Figure 1 shows this trade-off in the form of an *efficient frontier*, with cash anchoring the frontier on the low end and equities at the high end. Each investment merits a return based on the market's view of its risk, although some assets may lie below the line.

A defined benefit pension plan defines risk differently—it's the volatility of funding status, rather than the volatility of the asset portfolio, that matters most. Because liability values are calculated using market rates on high-quality corporate bonds, they are inherently sensitive to changes in interest rates and credit spreads.[2] In many cases, a tailored long-duration bond portfolio can effectively hedge away most of these risks inherent in the pension liability.

This *completely* changes how we view risk and return. Long-term bonds now become the "low-risk" asset because of their expected return that is similar to the plan's discount rate and a risk profile similar to the plan's liability (Figure 2). In this view, shorter-term bonds and cash are inefficient assets (below the efficient frontier) because they have lower expected returns, often lower than the discount rate, and a risk profile different than the plan liability.

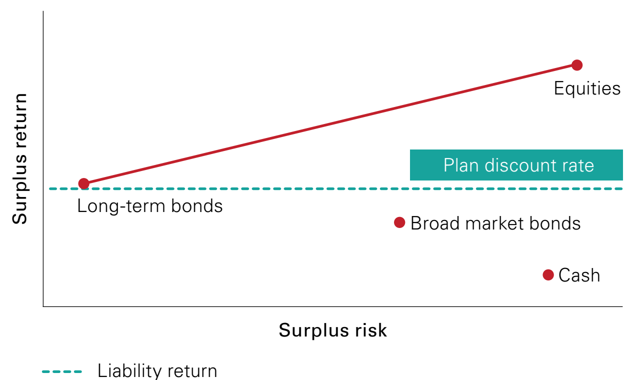
This change in the frontier is the key to what is commonly referred to as *liability-driven investing* (LDI), which focuses on managing interest rate and credit spread risk by optimizing asset and liability correlations. Return-seeking assets (such as public or private equity) can still be part of the mix, as they can add to the portfolio value by improving funding or covering the plan's service cost. But these assets represent *compensated risk* (more return) rather than the risk that shorter-term bonds bring, which is *uncompensated*.

**Figure 1. Total-return efficient frontier**




**Source:** Vanguard.

**Figure 2. LDI efficient frontier**




**Source:** Vanguard.

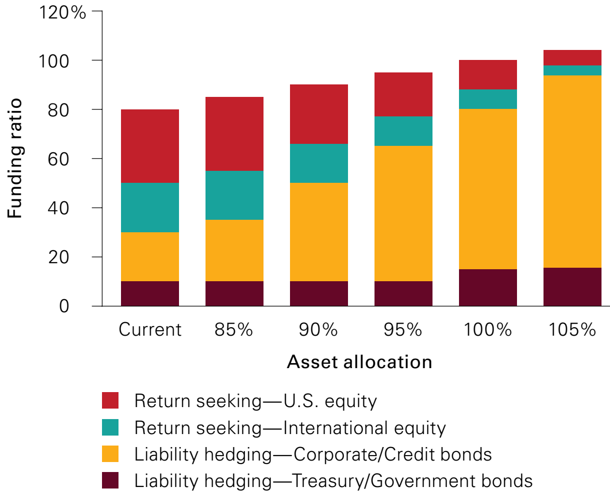
LDI approaches are appropriate for pension plan investing, even if the "L" is not as interest-rate-sensitive as a traditional pension plan. In particular, cash balance plans can have much less interest rate sensitivity, depending on their design. In many cases, an ongoing cash balance plan combined with a traditional pension benefit adds another layer of complication.[3]

2 See Gannon and Dutton (2019) for more information on the key drivers of pension liability risk.
3 See Gannon and Dutton (2018) for more information on investment strategies for cash balance pension plans.

Additionally, the pension portfolio can require significant adjustment as the funding ratio changes. Figure 3 shows a liability-driven investment strategy commonly referred to as a glide path, which reduces portfolio risk as the plan's funding ratio rises. The portfolio shifts can be dramatic. Properly executing these risk-mitigation strategies requires regular monitoring of the funding ratio to trigger action when certain funding levels are reached.

Once again, this differs dramatically from endowment or total-return investing; while both may have long time horizons, the altered risk definition and objectives lead to different approaches to portfolio design and management. It is important to realize that a skilled practitioner in total-return investing may not be proficient in pension investing too.

Figure 3. Glide-path strategies can call for dramatic shifts in asset allocation




**Note:** Asset progression is for illustrative purposes only and is not based on any particular portfolio.

**Source:** Vanguard.

### Capital market expectations

After years of strong results produced by the capital markets, return expectations have drifted considerably lower. As an example, consider that Vanguard's median 10-year return expectation for a traditional balanced 60% stock/40% bond portfolio hovers in the 3%–5% range.

The expectations for a bond-heavy, low-risk portfolio would be even lower. This type of environment can entice committee members to predict capital market movements, such as interest rates, or potentially add exposure to a tactical asset allocation strategy. Such considerations will test committees' investment acumen and demand additional investment expertise to make the best decisions for effective plan management.

## Pension plan management structures

Consider three structures for running a pension plan:

- In-house committee with internal support staff.
- In-house committee supported by an external consultant.
- OCIO that reports to the committee.

A self-supported, in-house effort must address all the above responsibilities, and more, on its own. For large organizations with substantial pension plan assets, perhaps global pensions, this could be a good choice; such organizations may be able to attract and retain the personnel necessary to execute these responsibilities effectively and at a reasonable cost.

A good consultant, with a solid background in pensions and sufficiently broad support, may be able to complement the in-house support staff, but the committee should still be pension savvy. The consultant can fill the gaps in their knowledge and tackle specific requests.

For situations in which gaps are substantial, an OCIO can offer additional coverage. OCIOs are expected to have broad expertise and experience with a variety of plan sponsors and customized pension objectives. We acknowledge the changing institutional advice landscape where terms and roles of a consultant and an OCIO may have started to blur; however, the following examples are based on the service models on each end of the "traditional consulting" versus "pure OCIO" business model.

Consider the structures from the perspectives of *portfolio management, fiduciary standing,* and *availability*:

### Portfolio management

Consultant: *Recommends* a strategy; the committee debates the course of action and then executes it. This can be challenging, considering the behavioral traps associated with group dynamics. Given the quarterly nature of meetings and time needed to complete requests, there can be a temptation to delay decisions until the next meeting and miss opportunities to execute the proper investment strategy.

**OCIO:** *Executes* the approved long-term strategy (e.g., glide-path reallocations) based on the investment policy statement (IPS). Given the OCIO's greater authority, there is no need for further debate for the investment committee (unless it is designed in), minimizing group decision-making challenges and reducing the potential for missed opportunities.

### Fiduciary standing

Consultant: In certain instances, the consultant does not serve as a fiduciary and so is not held to that standard of service/care. While we recognize the consulting environment has evolved over time to accommodate different client needs, a traditional consulting model would generally involve at most a nondiscretionary fiduciary engagement, i.e., as an ERISA 3(21) fiduciary. This is a relationship where investment advice and/or recommendations are offered and either approved or rejected by the plan fiduciaries. In short, the plan sponsor retains full responsibility for the investment decisions.

**OCIO:** The OCIO carries the responsibility of execution at the highest level. The OCIO generally serves as an ERISA 3(38) investment manager for the client and has discretionary authority to manage, acquire, or dispose of any asset in the plan. This type of fiduciary relationship involves investment decisions as opposed to just providing investment recommendations. A plan sponsor's duty then shifts to monitoring the investment performance of the OCIO as opposed to making each investment decision.

### Availability

Consultant: Can be hired for specific projects, which keeps recurring costs down. Plan sponsors must decide when it is appropriate to ask for help. Knowing that the cost clock starts with each request, sponsors may be reluctant to seek assistance.

**OCIO:** Always there to address issues as they arise. The depth of organization and available resources are fundamental to the success of the "call anytime" model. Cost of the service must be weighed against value added. As with the all-inclusive approach versus à la carte, you will likely use it more if it is already paid for.

Is an OCIO right for you?

Below is a set of questions with a sliding scale. Select the most appropriate answer for each question.

Figure 4. Pension preparedness questionnaire

| Your internal team has the: | Low | | | | High |
|---|---|---|---|---|---|
| Ability to establish, maintain, and operate an investment committee including governance, fiduciary requirements, and decision-making processes | 1 | 2 | 3 | 4 | 5 |
| Ability to set objectives for the pension plan while considering the variety of stakeholders involved | 1 | 2 | 3 | 4 | 5 |
| Expert knowledge of major asset classes, their characteristics, and their relationships to each other, including formulating and interpreting capital market assumptions | 1 | 2 | 3 | 4 | 5 |
| Ability to set an asset allocation that accounts for pension regulations and the potential impact to plan sponsor financials and is tailored to the characteristics of the pension liability | 1 | 2 | 3 | 4 | 5 |
| Expertise in portfolio construction, including the selection of major and sub-asset classes to include in the portfolio as well as the decision between active and passive investment strategies | 1 | 2 | 3 | 4 | 5 |
| Expertise in manager research including the selection and monitoring of investment managers to be placed within an asset class or portfolio | 1 | 2 | 3 | 4 | 5 |
| Ability to implement investment decisions and other portfolio changes (purchasing of securities, rebalancing, one-time asset allocation changes, glide-path implementation, and manager replacements) in a timely and cost-effective manner | 1 | 2 | 3 | 4 | 5 |
| Ability to monitor, report, and evaluate the pension investment portfolio based on return and risk management characteristics, as well as asset-liability statistics including funded status monitoring required for a glide-path strategy | 1 | 2 | 3 | 4 | 5 |

**Source:** Vanguard.

Given the impact the pension can have on the corporate entity, it could be argued that every category should score at least a 4 to ensure the internal team can handle all responsibilities effectively. If 3s appear, the plan sponsor should consider a consultant to assist with covering the gaps. If multiple 3s appear or there are scores below 3, a plan sponsor should consider looking for more complete help by hiring an OCIO.

## The role of the OCIO

**Establishing the OCIO relationship:** The required due diligence during OCIO selection will involve sponsor commitment based on the specific level of experience and expertise your plan needs. This is an important decision because the goal is to select a trusted advisor who will serve in multiple roles, including asset allocator, pension planner, behavioral coach, meeting coordinator, and risk manager.

The OCIO will generally function as a co-fiduciary and will be responsible for executing each phase of the long-term plan, serving as a reliable guide through any market environment. The OCIO's direction and execution will depend on their pension expertise. While thoughtful portfolio construction is important, the ideal partner will offer a broader perspective regarding planning and management of the overall process.

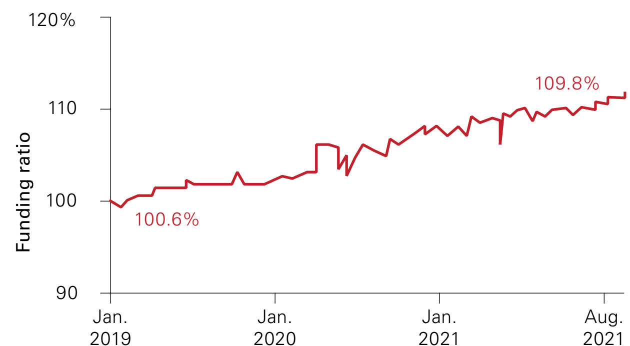
**Plotting the pension's course:** The IPS is the fundamental document for guiding the plan's strategy and its execution. While the typical U.S. corporate pension plan still has much to achieve in terms of funding status, the OCIO nevertheless should give special attention to the expected final phase or objective of the asset allocation during IPS construction. Determining this final phase can clarify the glide-path construction process and the steps between the current and future states of the plan.

Once at the final phase, many closed or frozen plans now consider a period of "hibernation" in which the asset portfolio primarily consists of liability-hedging assets or another low-risk strategy. A full plan termination is another option—one that many sponsors are interested in but not necessarily ready to fully execute. If those strategies are important to you, you should choose an OCIO who has experience with them. The goal of the OCIO will be to structure both the IPS document and committee meetings to foster effective progress and lower the barriers to action.

**Committee meetings—focus on what matters:** During committee meetings, recent investment performance is always a hot topic, but the majority of time should be spent on action items or those that affect the long-term plan. An OCIO's presence should enhance the focus on enduring goals such as portfolio allocation and balance, maintaining strategic discipline, and the effective management of plan costs. Topics such as specific manager styles and distinct economic events are interesting but represent areas in which a committee can add little value. Through OCIO guidance, committees should devote substantial time to long-term objectives, funding-status stability, and risk.

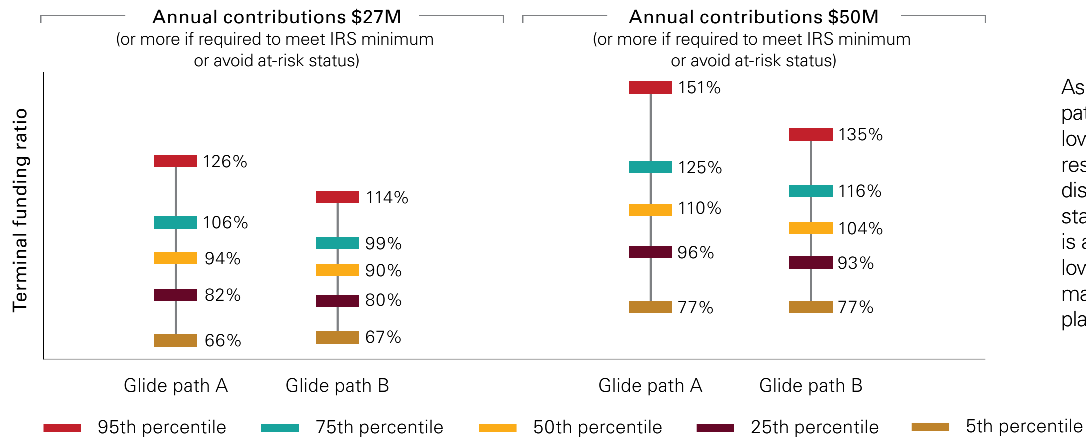
**Managing financial risk:** One of the key benefits an OCIO brings is consistent modeling and scenario analysis capabilities. While the OCIO must rely heavily on future assumptions, these quantitative tools help the OCIO detail potential worst- and best-case scenarios for funding status, contributions, and tracking error. This type of exercise can help set expectations and assist the committee with long-term planning. Two key examples of the consistent analysis provided through an OCIO are included below in Figures 5 and 6, including the plan's funding status on a daily basis and projections of how it could fluctuate over a 10-year period.

**Figure 5. Daily funding-status monitor**




**Sources:** Vanguard and PFaroe.

Figure 6. Projected funding ratio—10-year time horizon




As compared with Glide path A, Glide path B is a lower-risk approach that results in a narrower distribution of funding status outcomes. This is an example of a lower-risk strategy that may be preferred by a plan sponsor.

**Sources:** Vanguard and PFaroe.

**Operational risks—more than you thought:** While managing financial risk remains the top priority, there are operational risks in the plan activities that many sponsors take for granted. These many facets of plan management need to be executed on a consistent basis and can matter just as much as investment risk because of their potential impact. The OCIO has a unique window into all aspects of plan management, including transition management, rebalancing, liquidity, and reporting in various forms. Consider the following activities that require oversight:

- **Transition management:** The goal is to maintain exposure, to the greatest extent possible, to the capital markets through the portfolio assets. While many strategies can be employed, transferring securities directly (i.e., in kind) or using exchange-traded funds or futures are popular. A successful transition will reduce any frictions due to trading costs while maintaining hedging levels.
- **Rebalancing and reallocation:** Throughout each glide-path phase, the allocation will drift and require rebalancing. Various cash flows such as plan expenses, benefit payments, and, possibly, contributions need to be managed and accounted for in the portfolio. More significant shifts occur when the plan enters a new glide-path phase. When these "triggers" are hit, will the assets seamlessly move to the new target asset allocation? The time required to make these adjustments and the trading specifics are key responsibilities for the OCIO during its management of your plan.
- **Special events:** Managing the allocation and maintaining the desired hedging properties come into focus during events such as a lump-sum window, management of an annuity buyout, or transference of assets to an insurance company during a plan termination. Coordination among the plan sponsor, the plan actuary, and the OCIO is necessary given the amount of information required to manage the plan effectively during these events.
- **Effective management of plan costs:** The list of direct costs is extensive—investment expenses, advice, payment services, actuarial fees, custodial fees, etc.—but implicit costs should be considered too. Quiet detractors such as periodic downgrade risk, in even high-quality bond portfolios, can reduce funding levels over time. The plan sponsor needs to understand all associated costs.
- **Holistic risk management:** How does each segment of the portfolio contribute to the overall risk level? Each investment should have a clear goal and, in total, should contribute to a portfolio that matches a specific phase or objective in your IPS. Multiple layers of risk management and oversight are required, highlighting the need for an experienced team with deep resources. An OCIO may provide the pension expertise your organization needs in order to meet your unique objectives.

## Conclusion

The decision of whether to hire an OCIO is driven by the requirements of managing the corporate pension promise. Fiduciary due diligence, regulatory requirements, and the pension plan's corporate impact all point to the importance of this responsibility. You must determine whether you have the internal resources to meet these demands, whether you need to call on a consultant to cover for gaps in the skill set, or whether you need to hire an OCIO for a broader service.

Know that this job is ongoing and poses ancillary challenges: staying abreast of pension topics, maintaining the focus on the long-term plan, and orchestrating successful decision-making. Corporate leaders must decide whether these requirements are better met by an outside expert.

An OCIO should have expertise in the areas where your company/committee needs assistance the most, whether it's establishment of goals, ongoing investment management, or fiduciary support. Effective meeting management or skill in navigating volatile markets may also rank high on your list.

In the end, partnering with an OCIO can enhance your capabilities in pension management, from the basics of the investment policy statement to risk metrics to effective cost management and everything in between.

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