Discretionary Investment Management Working Group on Data Standards' Comment on CFA Institute's GIPS EXPOSURE DRAFT GUIDANCE STATEMENT FOR OCIO STRATEGIES November 20, 2023

Summary and Background of DIMWG

The Discretionary Investment Management Working Group on Data Standards (DIMWG) was formed in 2018 to focus on data standardization and transparency within the Chief Outsourced Investment Office (OCIO) industry. The goal of DIMWG is to create and document a set of standards that are highly usable and academically valuable to the end users of this data: the asset owners and the consultants serving them.

Purpose and Positioning Statement

As DIMWG participants represent the vast majority of OCIO assets under management in the United States and as the advisory committee of DIMWG represents leadership from many of the most tenured and largest market share representatives in the OCIO industry, we feel DIMWG's experience and consensus findings derived over nearly five years of collaboration on the very same topic that the GIPS Standards for Outsourced Chief Investment Officers Working Group (the "CFAI WG") has undertaken should be represented.

DIMWG applauds the work of the CFAI WG, many of whose members are also participants (either individually or at firm level) in DIMWG. This is a crucial undertaking to help steward the OCIO industry into its next phase of maturation and growth. We stand ready to assist in harmonizing the consensus agreements of DIMWG with the work of the CFA Institute going forward.

It is important to note DIMWG approached this topic from a different viewpoint than the CFAI WG. DIMWG sought to find and create a workable and valuable set of track record composite standards that allowed for meaningful and transparent comparisons amongst OCIOs. DIMWG's focus was to build composite data to facilitate decision-making by the asset owner, client, or prospect. In addition, we wanted the data to be relatively easy for OCIOs to compile and maintain and for it to be useful for comparison purposes by search consultants and third-party data aggregators. Though we were fully aware of generally existing GIPS standards and the need to have an inclusive and administrable standard, DIMWG and its advisory group did not adapt its framework from the existing GIPS standards; rather, we started with a blank slate focused on creating standards that were valuable and usable for the various stakeholders in the OCIO ecosystem.

As the members of DIMWG and its Advisory Board represent the interests and viewpoints of many different firms and OCIO industry professionals, the Advisory Committee of DIMWG determined it would be best to provide feedback to the CFAI WG in a simple compare-and-contrast approach. As such, below we answer and comment on the questions asked in the Exposure Draft. We did this by simply comparing the Exposure Draft questions with the discussions by DIMWG and any consensus reached through a vote of DIMWG participants.

As some of the topics raised by the Exposure Draft were contemplated by DIMWG but have yet to be addressed in a consensus finding, DIMWG will not render comment at this time but may acknowledge the topic herein. Any absence of agreement, contrast, disagreement, or comment regarding statements in the Exposure Draft does not imply DIMWG's agreement with the findings as stated.

Although there may be relevant commentary and opinions represented by the majority of DIMWG and its advisory group, this public comment from DIMWG as an entity will largely seek to leave the expression of those thoughts to the individual comments from DIMWG's participating firms and individuals.

Q1. Is it clear when a firm must apply the Guidance Statement for OCIO Strategies?

A: DIMWG recognizes the importance of this question and its precepts but has not contemplated the specific circumstances described in the Exposure Draft.

Composite Corridors

Determining what the appropriate breakpoints in creating corridors should be was the most challenging endeavor taken on by DIMWG. The general membership of DIMWG determined the best way to approach this was to split into two subgroups to discuss the topic. Applicability to current GIPS protocols was contemplated but was not meant to be a limiting factor. Over two years, the subgroups met, resulting in a presentation of each of their findings to the broader DIMWG group at the November 2022 meeting in Chicago. The corridors that would be appropriate for composite definitions were discussed in light of their value in making effective comparisons amongst OCIOs. DIMWG also factored the *number* of client mandates that would typically fall within a particular bucket from a use-case basis (e.g., seldom do return-seeking mandates fall below 50% in growth assets by policy). Consideration was given to smaller and emerging OCIOs that may not be able to sufficiently populate enough representation (i.e., sample size) in a given category. However, at the end of the day, the DIMWG consensus focused on the academic integrity of the data for comparison purposes and not on facilitating the interests of smaller and emerging OCIOs. It was determined that establishing corridors for the sake of inclusiveness was a *business motivation* and not focused on the interest of the asset owner. Such an approach could risk overly broad comparison data, sacrificing the effective usability and intellectual integrity of the dataset.

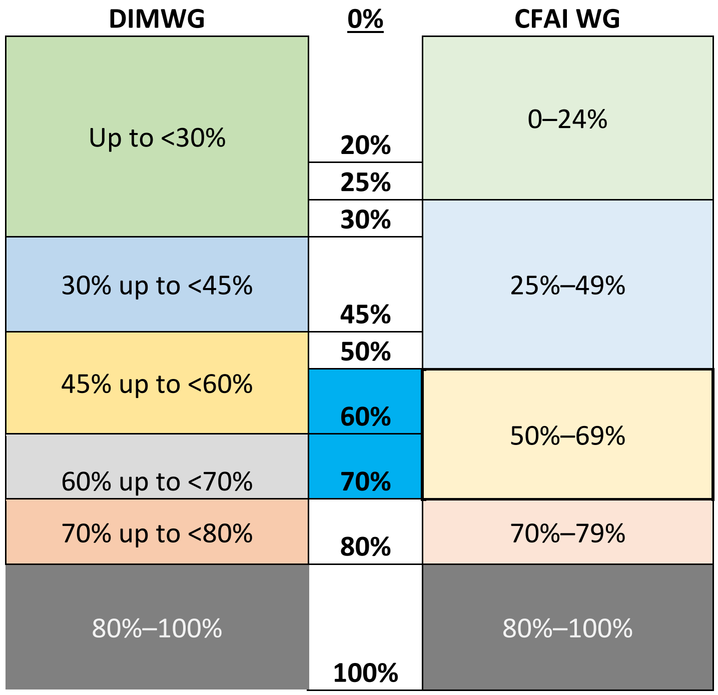
DIMWG ultimately agreed to the following return-seeking mandate corridors:

"Categorization of Growth Asset Classes for Compositing – approved by group consensus.

- **0 to <30%
- 30% up to <45%
- 45% up to <60%
- 60% up to <70%
- 70% up to <80%
- 80% or more"

These corridors reflect both the consensus of the typical mandates most represented OCIOs see in their clientele and the value of separating differing portfolio characteristics over varying allocations. **94%** of DIMWG participants voted to accept these corridors for composite definition at the November 2022 meeting.

Below is a comparison of the approved DIMWG consensus findings and the initial suggestion of the Exposure Draft:



(DIMWG: Discretionary Investment Management Working Group on Data Standards; CFAI WG: GIPS Standards for Outsourced Chief Investment Officers Working Group. For DIMWG data above, "<70%" means up to but not including 70%)

In preparation for the November 2022 meeting, DIMWG members were asked to look at the composition of their client allocations across their lines of business. It was generally noted that few not interest rate hedged OCIO portfolios (i.e., "liability-focused") have less than 50% growth asset allocations. It simply is not a common mandate in the OCIO world. Further, most DIMWG participants reported that the largest number of client mandates fell between 60% and 80% growth-seeking targets.

DIMWG felt dividing the most commonly used mandates (60%–80%) into 10% segments was most likely to support apple-to-apples comparison. Although DIMWG consensus and CFAI WG's findings were aligned for growth-seeking mandates at 70% or higher, our findings differed most materially in the corridors between 45% and 70% (as seen above). DIMWG highlights this difference for CFAI's consideration and provides an illustration for the CFA Institute's consideration:

> Contemplate the 41 basis point dispersion of expected return that a simple passive portfolio comprised of Growth-seeking (AC World Equity*) and Preservation (U.S. Aggregate Bonds*) experiences between the 50% growth-seeking and the 65% growth-seeking portfolios.

	% Growth		
	50%	60%	65%
Total Blended Return	6.45%	6.72%	6.86%
Difference from 50% Growth		0.27%	0.41%

* Expected return computed from the most recent JP Morgan capital markets assumptions for 2024 of U.S. Aggregate Bonds of 5.1% and AC World Equity of 7.8%.

DIMWG felt anything more than a 10% spread would be too wide a corridor for the often-used 60% and 65% return-seeking portfolios and may result in watering down the data and skewing results more based on the dispersion of *client objectives* and not the *variability of OCIOs' returns*. The CFAI WG's proposed spread is 20% in this crucial and well-populated band versus DIMWG's consensus of 10%. The illustration above shows expected variability of just 15%.

Liability-Focused Composites

The CFIA WG's approach to liability composites differs meaningfully from the findings of DIMWG. Due to complexities in the issue of grouping meaningfully symmetrical composites, DIMWG has yet to create standards for the treatment of liability-focused asset owners. This is primarily due to the impact of bond portfolio duration and duration-matching on portfolio performance. The CFIA WG's approach does not factor duration, a regularly significant impact on asset performance. Further, liability hedging is not solely dependent on the proportion of "Allocation to Liability Hedging Assets," as bond duration can vary regardless of the amount of assets used and derivatives can replicate substantial amounts of duration with far smaller amounts of assets.

In the world of liability driven investment ("LDI" or "liability-focused" as the Exposure Draft puts it), generally, portfolios that would be invested less than 50% in growth-seeking assets will be well funded, if not fully funded. Most of these portfolios do not seek significant growth and are heavily hedged against interest rate moves (via LDI). As such, the duration of that LDI implementation will drive the vast majority of performance and its volatility. Further, that LDI duration will be derived not from the OCIO's strategic views or manager selection, but from a combination of the desired percent of the hedge (which in plans with low growth-seeking asset proportions is likely very high) and the plan's duration of liabilities (e.g., an older participant demographic would have a shorter duration than a younger participant demographic). As much of the performance variance will be related to the individual circumstances of the plan and the corresponding duration of the hedging assets, caution should be taken when ascribing composite value to these heavily LDI-influenced composites unless duration is added as an additional defining factor.

The CFAI WG acknowledges this issue on page 6 of the ED but decided to forgo adding duration segmentation because, it could "lead to many complexities, including return calculation challenges" and that "many prospective clients might not fully understand the composite definitions," ultimately choosing a simplified overly broad approach "to make the composite structure understandable for clients." Though the structure may be *understandable*, the shortcomings are not clear, and therefore, the structure is misleading. None of these reasons speak to the fact that this approach leads to significantly varying performance amongst composites and composite members that little reflect the OCIO's prowess and instead, more reflect the type of liability-focused clients the OCIO caters to. For these reasons, it is questionable how valuable these composites would be in their current form and how misleading they could be to the end user.

DIMWG spent a great deal of time in several general and sub-group sessions attempting to address this issue and, in the end, decided, for the time being, to defer proposing a standard at all due to these complexities. DIMWG suggests that the CFA Institute not rush to propose an overly broad standard for liability-focused composites that does not address the intent of "fair representation and full disclosure." Not including liability hedging duration impact does not provide a "fair representation" of the OCIO's impact on the portfolio and does not "provide full disclosure," as it is silent on one of the two key driving factors of portfolio performance and its variability.

Q2: Do you agree with the use of a Required OCIO Composite structure?

A:, Yes. DIMWG came to a similar conclusion with overwhelming consensus. In fact, this was foundational in the formation of the industry-led working group on OCIO data standards and its subsequent five years of work towards forming a set of data standards.

Q3. Do you agree with differentiating liability-focused composites from total return objective composites in the Required OCIO Composite structure?

A: Yes. DIMWG came to a similar conclusion with overwhelming consensus. However, after deliberating in the general group and many subgroups over multiple years, DIMWG members decided to table the liability-focused issue until the return-seeking standards had been set and agreed to. There were far too many contributing factors that required more time for proper evaluation before reaching a consensus. DIMWG did contemplate a simplified approach to liability-focused composites (similar to the CFAI WG's). That approach was rejected by DIMWG for the reasons previously mentioned.

Q4. The proposed asset allocation ranges for the Required OCIO Composites have been created based on a widely used set of OCIO indices, which is built to include the most common 60/40 portfolio in the middle of the moderate bucket. Do you agree with these ranges, or do you think we should take a different approach?

A: DIMWG's findings do not support the CFAI Exposure Draft's depiction of its liability-focused corridors for the reasons detailed above. The CFAI Exposure Draft's decision to ignore the substantial impact of liability hedging duration will likely lead to data that does not accurately reflect an OCIO's performance due to the heavy influence of the asset owner's hedging directive and the resultant impact on asset values and performance.

DIMWG's consensus agrees with some of the return-seeking ranges proposed by the CFAI WG but finds material differences in the sub-70% band, especially from 50%–70% growth-oriented. Our findings are that a 10% delineation would be more appropriate in that highly used corridor. Please see DIMWG's discussion above for a complete review of our consensus position. Differences in the sub-50% categories are less meaningful due to low population of data and utilization expected.

<u>Legacy Assets</u>

Q5: Do you agree with the proposed three options for the treatment of legacy assets?

A: DIMWG's findings do not agree with the third option: "Include in composites the portion of the portfolio that excludes legacy assets when this portion of the portfolio is consistent with a Total OCIO Portfolio." DIMWG deeply contemplated the issue of the treatment of legacy assets and their impact on the inclusion of portfolios in OCIO composites. There is a material conflict between DIMWG's findings and those proposed by the CFAI WG. DIMWG found that in its definition of what did and did not constitute "discretion" regarding composite inclusion that "[p]artial accounts, e.g., individual asset class sleeves *or total portfolios ex-legacy assets"* would be considered "non-discretionary." This definition was agreed to with 91% of the voting participants of DIMWG. If any legacy asset is "considered unacceptable by the manager…the account should be classified as 'partial discretion' or 'non-discretionary' and will be considered to be ineligible for inclusion in performance."

DIMWG approved two methods for the treatment of legacy assets. The first, which in part is discussed above, was a "Contractual Approach." Under this approach, the determination of the treatment of a legacy would be determined by the OCIO and clearly stated in the IMA. "If the legacy asset is determined to be acceptable under the manager's current ratings, it can be treated as discretionary and included as such in the Investment Management Agreement." The second acceptable approach was a "Percentage of Portfolio Approach," which would set a maximum limit of "non-acceptable" legacy assets, which would be deemed by the OCIO as "non-discretionary." As long as the portfolio was under that maximum threshold, then the "*total account (including the legacy asset)* can be considered as eligible for inclusion in performance composites as of the appropriate date under current inclusion rules." At the December 2021 DIMWG meeting, the group voted on and approved the "Contractual Approach" and "Percentage of Portfolio Approach." Voting included:

- 100% voted that at least one approach is acceptable.
- 90% voted yes on the portfolio approach.
- 90% voted yes on the contractual approach.

Again, at least 90% of DIMWG membership voted to only include *total portfolio performance* regardless of the treatment of legacy assets.

Required OCIO Composite Returns and Fee Schedule Disclosure

DIMWG contemplated the issue of fee disclosure and the treatment of fees and various costs. There was general consensus that both the gross-of-fees and net-of-fees reporting were valuable. No vote was taken by DIMWG on this particular topic, but it was generally assumed. Further, DIMWG did discuss and delineate fee disclosure of all types discussed in the Exposure Draft. This discussion resulted in the unanimous consensus of the participating members of the November 2022 DIMWG meeting to adopt the "Final Fee and Cost Framework." Our comments will not compare and contrast that information for brevity purposes, but the DIMWG accepted format is submitted with this comment for reference. This is an open-source document.

Q6. Do you agree with requiring firms to disclose information about their policy for the treatment of legacy assets?

A: Yes. DIMWG sub-groups found that substantial and proactive disclosure of their policies for the treatment of legacy assets was paramount as it pertained to composite composition.

Q7. Do you agree with requiring both gross-of-fees and net-of-fees returns for Required OCIO Composites?

A: Though no vote on this subject was ever taken by DIMWG, gross-of-fees and net-of-fees return reporting was a general agreement amongst the participants in our discussions.

Additional Areas for Comment

The Exposure Draft's's lack of addressing illiquidity in the Exposure Draft

DIMWG's findings materially differ from those of CFAI WG's in the key area of a portfolio's allocation to, and budget for, illiquid assets. In contemplating breaking portfolios up by client type, DIMWG initially considered segmentations for asset owners by type (e.g., endowments, foundations, healthcare systems, and pensions funds). Ultimately, it was the finding of DIMWG (by 95% of the voting participants) that the key differentiator between these types of groups was simply their objectives and restrictions (e.g., maximum illiquid asset exposure).

As it is the general consensus in the OCIO industry that illiquid assets are *expected* to enjoy an illiquidity premium of 300 to 500 basis points or more, an asset owner's ability or appetite to take on illiquidity in their portfolio will likely have a meaningful impact on its performance. Similarly, the composition of a composite's representation of varying amounts of illiquidity in its member portfolios can have a substantive impact.

> *As an example, in a typical 70% return-seeking portfolio, with expected returns for public equities at an assumed 8% and an expected return for private equity of 11% (+300bps), an institution with a 40% allocation to illiquid private market equity versus an institution with a 0% allocation would enjoy a ~120 basis point advantage of assumed return before the impact of the OCIO's management.*

OCIOs who cater to one type of client that may have a more perpetual objective and thus a higher illiquidity budget would have a distinct composite advantage over an operating nonprofit that required substantial liquidity. Yet if the CFA Institute does not include some way of segmenting these very different clients and respective portfolios, these compositions would not be "fair representations" of the OCIOs' prowess or results.

DIMWG voted to establish corridor ranges for liquidity as well as a definition of what constituted an illiquid asset. CFAI would need to address illiquidity and its impact on composites to be consistent with the findings and consensus of DIMWG.

Currencies

DIMWG has not addressed the issue of currency hedging in its proceedings. As DIMWG has not contemplated the issue, we simply state that this is a valuable topic for discussion, and we welcome the CFAI WG's contribution.

Closing

DIMWG is in support of the undertaking that the CFA Institute and the CFAI WG have embarked upon. If we can be of further assistance by sharing DIMWG's findings, process, or experience with you, we'd be happy to do so to help further our similar missions and better the OCIO and institutional asset owner industries.

Many of the OCIO industry's leading thought leaders, representing the majority of the largest and most established OCIOs, as well emerging OCIOs, ERISA attorneys, third-party evaluators, and data aggregators contributed to this commentary and the discussions, meetings, and collaborations leading up to it. Due to various firm compliance policies and procedures, we have decided not to name them individually at this time. They know who they are and we are eternally grateful for their diligence and effort over the last five years. The responses contained herein may not fully reflect the views of each individual or their participating firms. However, I am confident that it represents the general collective thinking of the majority of DIMWG participants.

Submitted by:

Jim Scheinberg (North Pier Search Consulting)

of behalf of the following members of the DIMWG Advisory Committee:

Steve Charlton (NEPC)

Greg Metzger (North Pier Search Consulting)

James Modelski (Fiducient)

Travis Pruit (Mercer)

Todd Solomon (McDermott, Will, and Emory)

Grant Verhaeghe (CapTrust)