

# Is the OCIO Market a Red Ocean or Blue Ocean?

Current Status and Problems of the OCIO Market and Improvement Direction

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# Definition and Background of OCIO

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- Definition of OCIO (*Outsourced Chief Investment Officer*)
  - It is a method of asset management where an organization entrusts the management of its assets to a specialized firm.
  - This entrustment encompasses the entire investment decision-making process, including both strategic and tactical asset allocation, the selection of underlying asset managers, portfolio rebalancing, risk management, and the execution of investment decisions.
  
- Background of the Emergence of OCIO
  - The emergence of OCIO can be attributed to the growing need among investors in the capital market to delegate the execution of crucial tasks such as:
    - Selecting the right assets, implementing investment decisions, monitoring performance and risk
  - These tasks have become increasingly challenging due to the following changes in the capital market environment:
    - Increased volatility in the capital market, making it difficult to predict market movements
    - Rising costs associated with managing investment portfolios relative to the available investment funds

# Differences between OCIO and Traditional Investment Management

- Differences between OCIO and Traditional Investment Management
  - The biggest difference between the OCIO system and traditional investment management is the level of authority delegated in the investment decision-making and asset management execution stages.

Feature	OCIO	Traditional Investment Management
Roles and Responsibilities	<ul style="list-style-type: none"> <li>- Taking on part or all of the strategic decision-making process</li> <li>- Managing funds in line with strategic asset allocation</li> </ul>	<ul style="list-style-type: none"> <li>- Focusing on managing funds through stock selection</li> </ul>
Investment Structure	<ul style="list-style-type: none"> <li>- Fund of Funds (asset managers)</li> <li>- Wrap accounts (brokerages)</li> </ul>	<ul style="list-style-type: none"> <li>- Direct fund management</li> </ul>

Source: Nam, J. (2023)

# Distinguishing the OCIO System

## ■ Varieties of the OCIO System

- The OCIO system can be categorized into three main types based on the extent of discretion:

Category	Granularity of discretion
Full discretion	<ul style="list-style-type: none"> <li>- The organization delegates the majority of investment decision-making to an external specialized asset management firm.</li> <li>- The internal organization primarily focuses on governance responsibilities and formulating or revising the Investment Policy Statement (IPS).</li> </ul>
Partial discretion	<ul style="list-style-type: none"> <li>- Most aspects of investment decision-making, except for the highest level strategic decisions, are entrusted to an external specialized asset management firm.</li> <li>- The internal organization retains responsibility for formulating and revising the IPS, conducting ALM analysis and implementation, classifying funds into short-term, medium-term, and long-term categories, and determining strategic asset allocation.</li> </ul>
Limited discretion	<ul style="list-style-type: none"> <li>- Only specific functions that are difficult for the internal organization to handle are delegated to an external specialized asset management firm.</li> <li>- The discretion of authority is typically limited to specific asset classes or investment strategies.</li> </ul>

Source: Ministry of Economy and Finance (2017)

# Advantages and Disadvantages of Adopting an OCIO System

- Advantages and disadvantages of adopting an OCIO system
  - By introducing OCIO, the problem of internal resource shortages in terms of human and material aspects can be solved relatively quickly and cost-effectively by utilizing the expertise and information capabilities of OCIO in asset management.
  - Since the overall asset management is outsourced, it is difficult to accumulate internal capabilities and internalize the asset management system.

Advantages	Disadvantages
<ul style="list-style-type: none"><li>- Addressing resource constraints</li><li>- Cost-efficiency and time-effectiveness</li><li>- Enhanced risk management</li><li>- Improved investment performance</li><li>- Adaptability to financial markets</li><li>- Access to information and education</li><li>- Diversification of investment assets</li></ul>	<ul style="list-style-type: none"><li>- Managing uncertainty of fund disbursements</li><li>- Establishing clear OCIO roles and responsibilities</li><li>- Implementing oversight and monitoring mechanisms</li></ul>

# The Evolution of the OCIO in Korea

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- Introduction of the pension fund pool system (2001)
  - In 2001, the Ministry of Economy and Finance spearheaded the establishment of the Pension Fund Pool System, marking Korea's first foray into the OCIO model.
  - This system adopted a fund of funds structure, where funds were entrusted to primary managers (PMs), who in turn allocated them to secondary managers (SMs).
- Adoption of standalone OCIO by public pension funds
  - The Ministry of Land, Infrastructure and Transport took a pioneering step by introducing a standalone OCIO system for the Housing & Urban Fund.
  - This was followed by the Ministry of Employment and Labor's decision to adopt an OCIO system, primarily focused on the Industrial Accident Insurance Fund and the Employment Insurance Fund.
- Implementation of OCIO alongside the Pension Fund Pool
  - Inspired by these successful cases, several funds that had previously utilized the Pension Fund Pool began to introduce separate OCIO systems for a portion of their assets.
- Expansion of OCIO in the public sector

# Standalone OCIO – The Employment Insurance Fund & Industrial Accident Insurance Fund

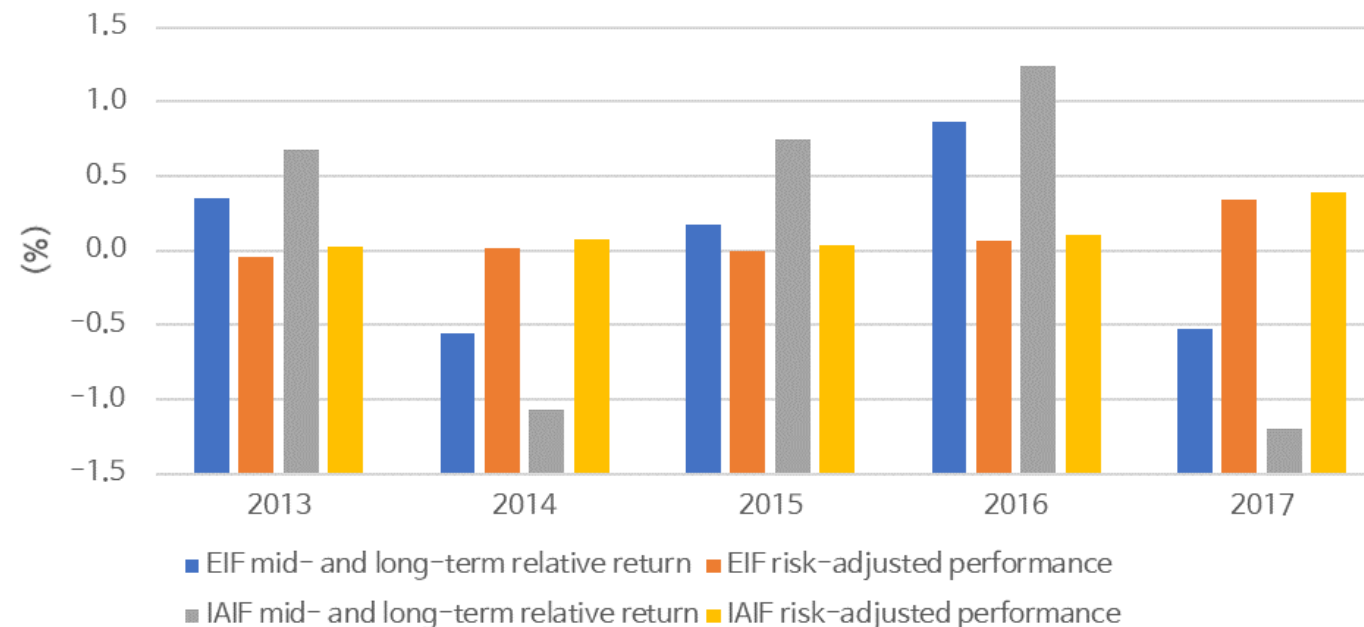
- The EIF & IAIF: Introduced a dedicated asset management system in 2015
  - The EIF was established in 1995 and the IAIF in 2002.
  - The Ministry of Employment and Labor's asset management team manages four funds: the EIF, the IAIF, the Wage Guarantee Fund, and the Employment Promotion Fund for Persons with Disabilities.

Feature	EIF	IAIF
Responsible Agencies	The Ministry of Employment and Labor	
Primary Asset Managers	Mirae Asset Securities	Samsung Fund
Recent Selection Date	April 2023	April 2023
Assets Under Management	6.6 tril.	21.7 tril.
Staff Size	34	25

Source: Korea On-Line E-Procurement System, Disclosed materials for each fund

# Standalone OCIO - The Employment Insurance Fund & Industrial Accident Insurance Fund

- Gradual improvement since the introduction of the OCIO
  - Mid- and long-term (1-year) relative return: No clear difference was found before and after the introduction.
  - Risk-adjusted performance (3-year Sharpe ratio): Shows a gradual improvement trend since the introduction.



Source: Ministry of Economy and Finance



# Standalone OCIO – The National Housing and Urban Development Fund

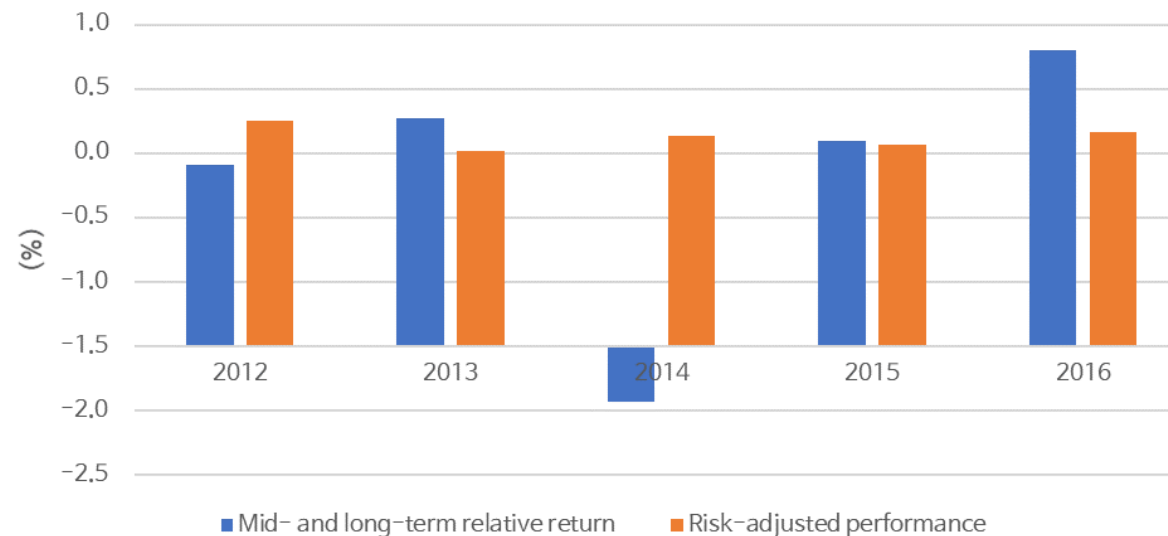
- The NHUDF: introduced a dedicated asset management system in 2014
  - The National Housing Fund, established in 1981, was reorganized into the NHUDF in 2015.
  - In 2014, a dedicated asset management system utilizing multiple primary asset managers was introduced to systematically manage the fund's growing surplus funds.

Feature	NHUDF	
Responsible Agencies	The Ministry of Land, Infrastructure and Transport	
Primary Asset Managers	Mirae Asset Global Investments	NH Investment & Securities
Recent Selection Date	April 2022	March 2022
Assets Under Management	20 tril.	20 tril.
Staff Size	(approx.) 20	(approx.) 20

Source: Korea On-Line E-Procurement System, Disclosed materials for the fund

# Standalone OCIO - The National Housing and Urban Development Fund

- Gradual improvement since the introduction of the OCIO.
  - Long-term (1-year) relative return: No clear difference was found before and after the introduction.
  - Risk-adjusted performance (3-year Sharpe ratio): Shows a gradual improvement trend since the introduction by rating:
    - Before the introduction of the OCIO, it was at a level between "unsatisfactory" and "good".
    - After the introduction, it changed to a level between "good" and "excellent".



Source: Ministry of Economy and Finance

# Full discretion – National Pension Fund Investment Pool

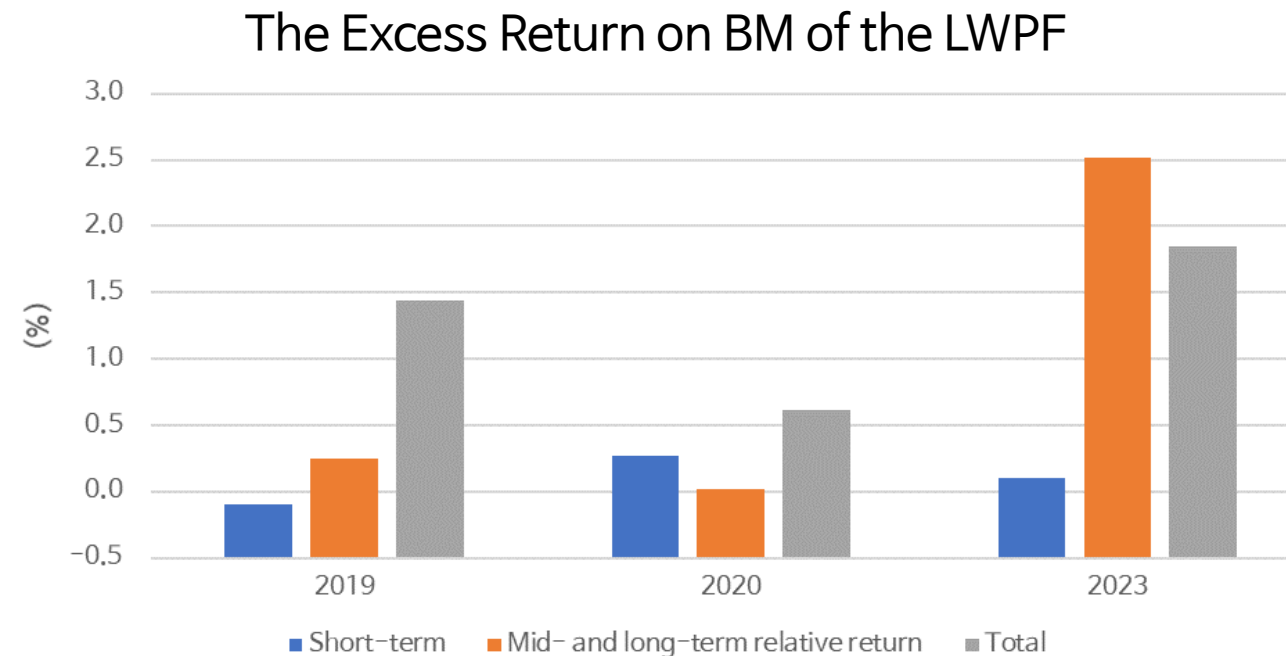
- Out of 52 small and medium-sized funds (10.6 trillion won) with idle funds of less than 1 trillion won, 27 funds (2.7 trillion won) participated in the fund.

Asset Management Operations		Pension Fund Pool	Full Discretion
Establish Investment Strategies	Formulate idle fund investment policies for each fund	Fund Pool	Primary Asset Managers
	Estimate appropriate liquidity	Fund Pool	Primary Asset Managers
	Conduct strategic asset allocation	Fund Pool	Primary Asset Managers
	Asset management guideline revisions	Fund Pool	Primary Asset Managers
	Review asset management guideline revisions	Fund-specific Committees	Investment pool operation committee (Asset management subcommittee)
Investment Execution	Tactical asset allocation	Fund Pool	Primary Asset Managers
	New idle funds to integrated funds	Fund Pool	Primary Asset Managers
Performance Evaluation and Risk Management	Report investment performance	Fund Pool (outsourcing)	Fund evaluators
	Evaluate investment performance	Fund-specific Committees	Investment pool operation committee (Asset management subcommittee)
	Report operational risks	Fund Pool (outsourcing)	Administrative officers
	Manage operational risks	Fund-specific Committees	Investment pool operation committee (Asset management subcommittee)
	Manage market risks	Fund Pool (outsourcing)	Primary Asset Managers

Source: Cho(2022)

# Full discretion – The Labor Welfare Promotion Fund

- The LWPF: has participated in the NPF investment pool since 2022
  - To address the limitations of small fund management capabilities, the fund has participated in the NPF investment pool.
  - It is showing signs of improvement since the transition to OCIO.
    - However, there is a low correlation between the fund's target return rate and the transition to OCIO.



Source: Korea Worker's Compensation & Welfare Service

# Combination OCIO – The Radioactive Waste Management Fund

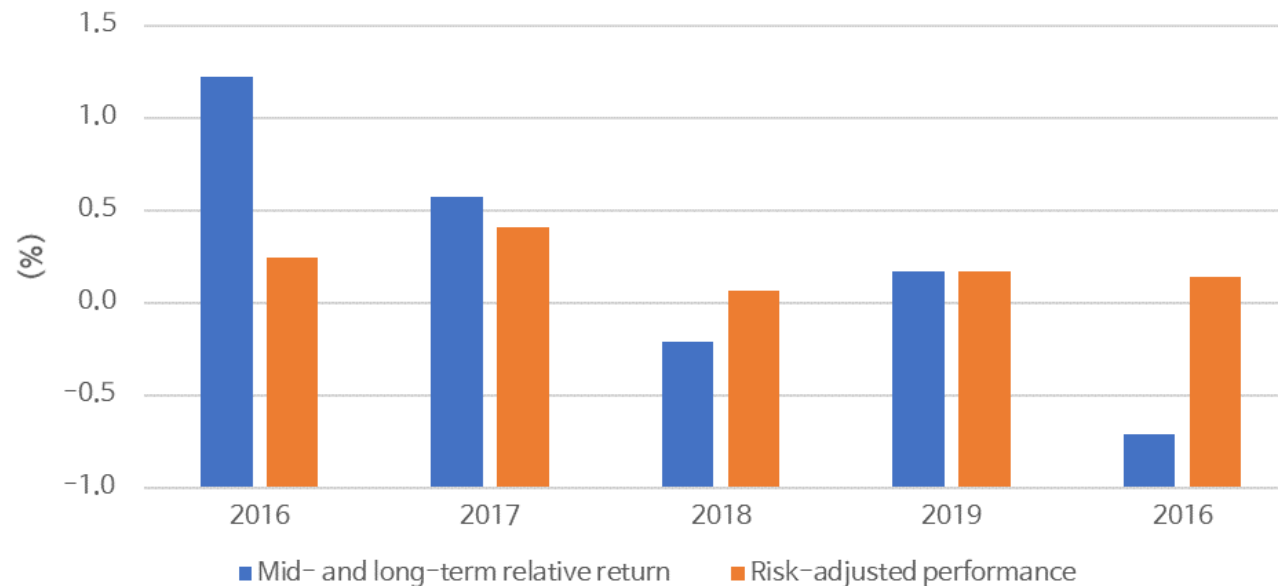
- The RWMF: a combination of the NPF investment pool and OCIO since 2018
  - Using a combination of the NPF investment pool and OCIO until the fund's size > 5 trillion won.
  - The primary asset manager performs tactical asset allocation, constructs and manages individual asset manager pools, directly manages some short-term funds, and provides asset management consulting services.
  - Approximately 1.5 trillion won is entrusted in the NPF investment pool.

Feature	RWMF
Responsible Agencies	Ministry of Trade, Industry and Energy
Primary Asset Managers	Shinhan Asset Management
Recent Selection Date	April 2021
Assets Under Management	2.1 tril.
Staff Size	13

Source: Korea On-Line E-Procurement System, Disclosed materials for the fund

# Combination OCIO – The Radioactive Waste Management Fund

- Downward trend since the introduction of OCIO.
  - Medium- to long-term relative returns (1-year relative returns) have been declining both before and after the introduction.
  - Risk-adjusted performance (3-year Sharpe ratio) has also been relatively low since the introduction.



Source: Ministry of Economy and Finance

# Oligopoly in Domestic Public Pension Funds

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- Over time, the structure of oligopoly by large companies has become more prominent.
  - This is especially evident in public pension funds, which account for over 80% of the total market (Nam, 2022).
- Unlike large asset managers, small and medium-sized asset managers face difficulties in entering the OCIO business.
  - Large asset managers hold over 90% of the market share in the OCIO market (Lee, 2022).
  - The following are the main factors cited for this concentration in large asset managers (Lee, 2022):
    - Entrustment of funds from affiliates, large investment capacity, movement of funds to a stable place, etc
  - Large asset managers are taking the lead in specializing their organizations
- Several solutions have been proposed, such as reforming the selection method of primary asset managers (Yang, 2022).
  - In addition, it may be possible to consider limiting the amount of funds that can be managed by a single asset manager or expanding the multi-management system (Yang, 2022).

# Short Primary Asset Manager Reappointment Cycle

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- OCIO is not immune to the principal-agent problem that is common in many business relationships.
  - Even with strong performance-based incentives, the issue of the primary asset manager reappointment cycle can still lead to a significant divergence between the goals of the asset owner and the goals of the OCIO firm.
- For large funds, it is common to have a primary asset manager reappointment cycle of four years.
  - Typically, a significant portion of the first year is spent on understanding and adaptation for the business and fund.
  - In the final fourth year, the primary asset manager must balance their regular duties with preparing for the reappointment process, which can lead to an increased workload.
- Alternatives are needed that consider the pros and cons of reappointment cycles.
  - There are several complex issues to address, including fairness, transparency, preventing monopolies, increased costs, reduced efficiency, and goal misalignment due to a focus on short-term performance.



## Excessive Dedicated Organization Requirements and Low Management Fees

- High weight of dedicated organization evaluation in primary asset manager selection
  - The relatively high proportion of evaluation items for manpower and price in the selection of OCIO companies is a burden on the OCIO industry.
  - Major public OCIO funds require dedicated organizations separated by Plan-Do-See functions.
  - Can lead to an adverse selection problem and have a negative impact on the OCIO market itself.

### An Example of the Evaluation in the Selection of OCIO

Price evaluation	Price(10)			10
Technical evaluation	Quantitative Measure	Human resources	8	30
		Operational assets	10	
		Operational performance	12	
	Qualitative Measure	Understanding of institution (or fund)	6	60
		Organizations and systems	18	
		Operational strategy	18	
		Support plan	18	

## Excessive Dedicated Organization Requirements and Low Management Fees

- OCIO is only feasible for funds > 5 trillion won in AUM (Nam, 2022)
  - Based on the following example, it is considered that operating a dedicated organization would be desirable for funds with AUM of 10 trillion won or more.
  - Assuming a fee rate of 3bp, which is commonly applied in the domestic OCIO market.
  - Scenario 1 and 2 assumes an annual salary of 100 and 50 million won per person, respectively.

Case	AUM (mil. won)	Fee rate (bp)	Operating income (mil. won)	BEP (workforce)	
				Scen. 1	Scen. 2
1	100,000	3	30	0.3	0.6
2	500,000	3	150	1.5	3.0
3	1,000,000	3	30	3.0	6.0
4	5,000,000	3	1,500	15.0	30.0
5	10,000,000	3	3,000	30.0	60.0
6	20,000,000	3	6,000	60.0	120.0
7	30,000,000	3	9,000	90.0	180.0

# NPF Depletion and Expansion of the Retirement Pension

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- NPF: Accumulating deficits starting in the next 20 years
  - The NPF is projected to have a surplus of revenue over expenditure for the next 20 years, followed by a period of accumulating deficits. (NPS, 2023)
  - The accumulated fund is expected to reach a peak of 1,755 trillion won around 2040 and be depleted by 2055.
  - Current largest fund's depletion and reduction could lead to contraction of OCIO market.
- Retirement Pension Market: Projected for continued growth
  - The retirement pension market size is estimated to reach approximately 382 trillion won by the end of 2023 and 940 trillion won by the end of 2033, a decade later (Korea Investment Management, 2023).
  - The performance-based retirement pension segment is particularly expected to grow, with its size projected to increase from 49 trillion won in 2023 to 269 trillion won in 2033.

# Summary and Conclusion

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- The Stagnant Growth of the Domestic OCIO Market: Challenges and Opportunities
  - Despite its quantitative growth over the past two decades, the domestic OCIO market has stagnated in terms of qualitative development,
  - Pushing OCIO firms towards a red ocean environment where achieving meaningful operational profits is becoming increasingly difficult.
- Key Challenges:
  - Information Asymmetry
  - Oligopolistic Market Structure
  - Short Reappointment Cycles
  - Excessive Dedicated Organization Demands and Low Management Fees
  - Uncertainty from Future Fund Size Changes