PRIVATE WEALTH MANAGEMENT
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Time for a New Narrative

Amin Rajan and Nick Lyster

Like other bear markets, the recent one will pass. But its memory will long endure. Once the worst of the current turmoil is over, the old normal will not be the new normal. According to a global survey, high-net-worth individuals (HNWIs) will seek quality, simplicity, and safety. Quality will be defined by consistent risk-adjusted returns, simplicity by transparency and liquidity of the strategies being used, and safety by capital protection. There will also be periodic opportunism to capitalize on the mispricing of distressed assets.

From Risk to Uncertainty

Clients know that safe, liquid assets mean low returns. Many are unwilling to buy into the risk premium story for the foreseeable future. The scale of recent losses is the immediate cause of the loss of investor confidence. But it had been eroding for a long time.

First, the buy-and-hold strategy did not work because bonds outperformed equity over a long period. Second, the core-satellite approach did not work because actual returns diverged markedly from expected returns for most asset classes. Third, diversification did not work because excessive leverage ramped up the correlation between historically uncorrelated asset classes.

Thus, for clients, the new normal will be about "buy what you understand; understand what you buy." It is influenced by discontinuities in the investment landscape that are driven by four sets of factors that have blighted the investment landscape in this decade: excessive leverage, two of the four worst bear markets of the past 100 years, accounting and regulatory changes, and aging populations. The resulting shockwaves have ensured that clients no longer manage risk, they manage uncertainty. One relies on expected returns on different asset classes, the other on pure guesswork.

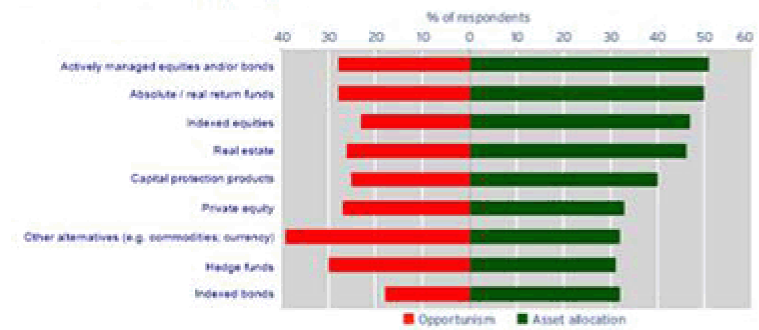
At the end of a traumatic decade, it is hard to imagine that nothing will change after everything that has happened. Asset managers need a new narrative about what they stand for and what they can deliver.

Clients are wising up. That much is clear from the likely investment behaviors of HNWIs, according to a survey conducted by CREATE-Research and commissioned by Citi and Principal Global Investors.

More for Less

Compared with their retail peers, HNWIs are likely to retain a more pragmatic risk profile. In the near term, the majority are likely to venture into active and passive products in the long-only space (see diagram). Their allocations to alternatives will be initially lower than in the precrisis days and more opportunistic than strategic. There are a number of contributing factors.

Once the worst of the current crisis is over, which asset classes and generic products are most likely to be favoured for short-term opportunism and/or medium-term changes in asset allocation by high net worth clients?



Source: Citi / Principal / CREATE Survey 2009

The first is the failure of risk models. When models failed, as they did, many HNWI clients were advised to be opportunistic until the dust settled and a new framework emerged. The old models failed to factor in the new world of finance, in which a company is linked to a monoline insurer, which is attached to a credit default swap, which is underwritten by another insurance company. It was hard to know the players who were involved and whether they had a problem.

The second factor is the failure of hedge funds. HNWIs had powered their growth in the belief that their downside risks were hedged, only to find that that was not the case. In 2008, HNWIs accounted for 80 percent — around US$500 billion — of hedge fund redemptions, even though they held less than two-thirds of the assets. The long-term affinity with hedge funds has weakened, albeit temporarily. Hedge funds are now perceived as a high-dispersion space for pursuing the best uncorrelated returns, so long as one chooses the right managers. In a low-volatility environment, hedge funds were forced to use leverage. Now, in a low-leverage, high-volatility environment, the best ones are expected to do well. Moreover, as global equities have effectively shed all their gains notched up between the Asian economic crisis of 1997–1999 and the onset of the credit crisis, they are no longer perceived as the only engine of decent long-term returns.

Third, the new inflows are likely to emanate from a new generation of entrepreneurs in Asia, the Middle East, Africa, and Latin America, with personal assets in excess of US$50 million. Most of them believe that now is their once-in-a-generation opportunity to make money. At the same time, they are far more demanding than their peers in the United States and Europe, many of whom are sitting on inherited wealth. They are especially sensitive to the counterparty risks associated with prime brokers, custodian banks, and structured products. They realize that "fat tails" proved to be the downfall of fat cats in the banking world. Accordingly, they factor in extremely adverse events in their investment choices. They also scrutinize their asset managers' client lists, looking for names that may bail out at the wrong time and hurt the returns.

New Growth Engines, New Challenges

Between the peak in October 2007 and the trough in November 2008, the stock market losses totaled US$21,000 for every individual in the developed world. In the high-net-worth segment, the losses were even more staggering. And yet, the segment is set to grow.

Over the next five years, assets in the private wealth industry will grow at a CAGR of 7.5 percent. Europe and North America will remain the epicenter, but the growth engines will be the Middle East, Africa, Asia-Pacific, and Latin America, in that order. The bulk of the new wealth will come from business entrepreneurs running the emerging-market multinationals, in marked contrast to the inherited wealth held in Europe and the United States. This development has a number of implications.

To start with, wealth managers are expected to develop the necessary client proximity by setting up offices in far-flung jurisdictions.

Furthermore, these clients want one-stop-shopping solutions that are normally associated with family offices. Finally, they want their wealth managers to help them raise capital from time to time to leverage both their business and their financial assets.

On the investment side, their demands are complex and heterogeneous. Being entrepreneurs, they are more demanding, less trusting, keen to manage their own affairs, less loyal, and more interested in growing their wealth. Around 65 percent of their assets are in active equities and bonds and nearly 15 percent are in alternatives, mainly hedge funds. The latter have declined substantially in the current bear market because of large losses incurred in the fund of hedge funds. Although interest will revive once the current turmoil is over, counterparty risk has come under sharp scrutiny. Over the next three years, three other developments are likely.

First, the bulk of investments will be active equities and bonds with zero tolerance of managers who cannot deliver the benchmark returns. Liquidity will become more important as regular dynamic switching becomes the norm. Hedge funds or anything illiquid will be frowned upon, unless they are part and parcel of high-conviction investing. There will be greater interest in domestic market investment because investors prefer more familiar ground at a time of heightened uncertainty in the global economy.

Second, part of the portfolio will be earmarked for ESG (environmental, social, and governance) investments as an alternative to philanthropy. In the Middle East, Indonesia, and Malaysia, Shariah-compliant products will become more popular.

Finally, product push will be replaced with a more collaborative approach to portfolio construction, one that involves clients and their relationship managers.

These developments will continue to have huge implications for wealth managers in the United States and Europe. They will need a strong local presence in manufacturing and distribution. They will need investment and noninvestment skills to provide a bundle of services. They will need a large army of relationship managers well versed in local cultures, languages, and traditions. It all adds up to financial intermediation at the level of a superservice provider.

No wonder most wealth managers are already struggling. Long used to having captive clients that were attracted to places like Luxembourg and Switzerland by the prevailing banking secrecy laws, these managers are now forced to make painful adjustments. They have lately been decoupling from their in-house asset managers. They must either develop onshore manufacturing capabilities or form alliances with good local managers, who are few and far between. They also need an offshore client relationship infrastructure at a time when the requisite skills are thin on the ground.

Conclusion

If there is an overriding message from our survey, it is that wealth managers must stop selling what they have and start selling what their clients need by creating products that are fit for the purpose. The new generation of clients has a near-zero tolerance for old-style mediocrity.

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