Toward a New Framework for Private Wealth

TO IMPROVE PERFORMANCE, BETTER INVESTMENT PROCESSES ARE NEEDED

By Pranay Gupta, CFA

Institutional investment management has evolved over the years to become a more transparent product industry. Competitive pressures have led to greater efficiency in investment processes, better risk management, lower fees, and greater alignment of interest between the asset owner and the asset manager. But private wealth management has been driven historically by the need for privacy, legal structures to protect ownership, and intergenerational transfer of assets. In this framework, the client had a relationship with the individual banker rather than with the banking institution. The result was a less effective investment structure for client assets because both the client and the banking institution did not consider management of the assets as a prime objective.

As the legal environment has evolved, the situation for private wealth has also changed in three important ways: (1) privacy is no longer possible, (2) global legal structures are more readily available in a cost-effective manner, and (3) strength of institutions has become a bigger factor for a banking relationship. Consequently, the value of the investment proposition for private wealth assets has come into focus. For client assets to be managed with a more efficient investment proposition, changes will be necessary in the private wealth investment industry. What changes are needed, and what would be the challenges of making such changes? This article outlines possible solutions.

THE INVESTMENT PROBLEM

The requirements of a private client are exactly the same as for any kind of institutional asset owner: to generate a defined, absolute, nominal, or real return with a constraint on the risk to be taken. Thus, at first glance, it would seem that this requirement can be tackled in exactly the same way as a traditional institutional plan sponsor's portfolio problem. But eight key differences make the private wealth investment problem more difficult to solve and implement.

(1) A TRUE ABSOLUTE-RETURN REQUIREMENT. Private wealth portfolios come with a constraint on maximum use of hedge funds, implying that the requirement of absolute return has to be met by a solution in which one is long market risk in all asset classes at all times. This is a difficult investment problem.

Institutional asset management sidesteps the absolute-return long-market investment problem in three different ways. First, for long-only products, the solution is having a long market index as a benchmark. Second, for absolute-return products, the approach is to use the ability to short. Third, for multi-asset products, a hybrid of asset class market indexes is used as the benchmark. Plan sponsors do the same by creating a "policy portfolio," which they use to transform the absolute-return problem of the plan into a relative-return problem to be followed by the managers.

In the private wealth world, however, because discretionary mandates give full control of the investment process to the asset manager, the difference in risk exposure between long-only investments and an absolute-return requirement falls within direct responsibility of the manager and cannot be sidestepped to a policy portfolio or a hybrid benchmark. This constraint imposes a true absolute-return investment problem, which in practice is more difficult than the institutional investment management problem.

(2) CUSTOMIZATION. Institutional investments mostly fit into a common framework in which assets are invested in multiple commingled fund structures (internal or external). Private wealth is distinguished by the fact that every single client specifies constraints and preferences to be incorporated into the portfolio, resulting in limits on investments, liquidity, leverage, single stock holdings, home bias, intergenerational requirements, and cash flow. Given the large number of accounts in private wealth, the customization requirement is a problem for large-scale implementation. Even though the manager may have a single market view, all accounts are different and each one needs a different portfolio.

(3) ACCOUNT SIZE. The investment process in an institutional product can be created for a single portfolio size, at any given time, be it a large or small asset base. In the private wealth setting, however, there can be accounts of dramatically different sizes that need to be managed at the same time. Accordingly, the investment process needs to be simultaneously applicable and relevant to very large and very small account sizes.

(4) DEFINED TIME HORIZON. In institutions, although intra-horizon drawdowns are painful, the agency structure serves to delink any emotional attachment to the assets, thereby decreasing behavioral biases in investment decisions. Because private wealth is very much an emotional attachment for the owner, the tolerance for intra-horizon drawdowns is far less. This intolerance has a definitive impact on the possibilities of the portfolio that are feasible or optimal for private wealth clients.

(5) LIMITATION ON DERIVATIVES. The segregated legal structure of institutional assets affords their use as collateral for non-delta-one derivative investments. In the private client world, trying to make such an arrangement for every single client account is cumbersome and limits the types of instruments that can be used to gain or hedge exposure in a private client portfolio.

(6) COST OF MANAGEMENT. The business model of private wealth relies on sourcing revenue from multiple points of the asset base, including flat fees for the total account, transaction fees for every trade or investment, wider bid–ask spreads, and a management and performance fee for investment products. Because of the multiple levels of fees, private wealth assets must clear a higher hurdle than institutional assets (which don't have these costs) to deliver a similar net-of-fees return.

(7) DIRECT STOCK HOLDING. Private clients have a bias in favor of direct holding of stocks rather than investment in funds. Although this bias is mostly emotional, a rational argument can be made for it. Directly holding a stock is appropriate if the objective is an absolute return (and a drawdown is acceptable), rather than holding a stock inside a fund (for which the objective is market-relative performance).

(8) THE BUSINESS MODEL. Private wealth has always had a service-oriented business model in which a critical component is to include services from other parts of the bank in the asset structure. This kind of arrangement can take the form of using internally managed funds from the bank's own asset management division or using "favored" external managers. Both approaches lead to incurring higher trading and implementation costs. In institutional asset management, the economic interests of the client and asset manager are aligned toward minimizing frictional costs, but in private wealth management, these interests diametrically oppose each other because higher implementation costs are direct revenue for the asset manager. Furthermore, the fact that private wealth is a service business means that the relationship manager for the client is more central to all portfolio decisions than is the portfolio manager.

Given these eight structural differences, a standard institutional investment process cannot be directly imported to solve a private wealth problem.

INCUMBENT INVESTMENT FRAMEWORKS

The traditional investment solution for private wealth assets was based on the concept of a 60/40 balanced portfolio, with some variations. The risk level of the portfolio could be varied to cater to the asset owner's risk aversion, allowing for conservative and aggressive portfolio solutions. Based on this conventional framework, four investment approaches have been tried in private wealth. First, in decentralized portfolio management, each relationship team manages its portfolios independently. This approach dilutes investment uniformity but brings the portfolio closer to the client. Second, in a core–satellite portfolio structure, every account invests in a single, core investment product that is internally managed. The remainder (or "satellite") of an account is managed on an *ad hoc* basis. A third approach is the core packaged set of internal funds, in which a core set of in-house investment products is used for all accounts but the account itself is left to be managed by the relationship manager on an advisory or discretionary basis. Finally, with the standardized house view, a single investment view is recommended and implemented with different degrees of rigidity, depending on the account mandate.

All four models fail to tackle the structural problems described earlier in this article. Moreover, they have the same defect: A single investment decision on the percentage of equity exposure in the portfolio, driven by a single investment process, dictates the success or failure of the portfolio. Given that market timing cannot be done sustainably, the portfolio is therefore always prone to failure at some point.

ALTERNATIVE INVESTMENT FRAMEWORKS

With all of these difficulties in mind, three alternative frameworks offer the potential to address many of the challenges in private wealth.

(1) A PRIVATE WEALTH MANAGER PLATFORM. Consider a private wealth platform in which professional fund managers make their full portfolio holdings available on a live basis. Through the platform, clients would have the ability to invest in any of the funds or directly in the underlying assets of any fund. The fees should be the same, so the manager and firm should be indifferent as to the implementation choice. The client's portfolio could be rebalanced according to the client's choice or the bank's advice (depending on the mandate), and the client could choose to define any constraints, which could be taken into account. Although portfolio holding replication would not be feasible for specific products, such as hedge funds and illiquid funds, this structure would solve a number of critical issues. It would allow full client customization, facilitate direct stock holding, retain the financial revenue base for the firm, allow security decisions to be taken by a professional fund manager (yet leave the implementation control with the relationship manager), allow a single investment platform for advisory and discretionary clients, and reduce the bias toward in-house funds. This structure is already present in institutional asset management for large customized managed accounts (as well as in the alternatives world), where it facilitates greater transparency and better risk management. There seem to be sufficient reasons why this structure should also find traction in private wealth asset management.

(2) A GROUP OF THEMATIC PORTFOLIOS. First-generation wealth creators often have definitive views on global economic dynamics that are better articulated as trends or themes rather than as equity–bond allocation decisions or stock selections. With this kind of client in mind, what if a private bank's investment team were to create and manage transparent security portfolios that capitalize on specific thematic objectives? In an advisory mandate, the client could choose the theme that seems likely to play out and allocate (and rebalance) assets accordingly. In a discretionary mandate, the bank portfolio managers could take the allocation decision as well. This approach would offer three advantages. First, equity–bond allocation decisions would be taken at multiple times and for differing reasons (creating diversification). Second, the client's views would be incorporated while the investment team's expertise still would be used. Finally (and most importantly), an implicit time horizon would be created for each theme, leading to more realistic risk–reward tradeoffs for the client.

(3)ALLOCATING TO CLIENT OBJECTIVES. Institutional allocation frameworks often begin with asset class allocation (an approach also followed in private wealth), but several plan sponsors have a liability-driven investment (LDI) approach. Although the LDI framework cannot be explicitly followed in private wealth because there may be no specific liabilities to match, one could begin by allocating to client objectives rather than to asset classes. Such objectives could include liquidity, yield to maturity, growth, short-term asset selection, illiquidity premium, active allocation, and stable shareholding. Each of these concepts comes with a defined investment horizon and an inclination as to the equity–bond decision. Again, although this framework may not solve all the problems of private wealth management, it could help align the expectations of the client with the realities of the portfolio and allow the implementation of client objectives while retaining account control with the relationship manager, supported by the investment strength of the investment manager.

PRACTICAL SOLUTIONS

Investment processes followed by private wealth need to improve to deliver better performance and risk management but must do so in a manner that does not compromise customization and service quality. I have proposed some potential solutions that would satisfy the requirements normally specified by private clients for their assets and also would enable the formation of portfolios with the institutional strength of investment decision making. Because these frameworks would be minimally disruptive to organizational structures, I believe these approaches are potential options for private banks to consider.

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