Evolving the Investment Framework for Private Wealth Investment Management

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While institutional investment management has evolved to become more sophisticated and performance driven, private wealth management has largely been neglected from an investment process perspective. Although similar to the institutional investment problem in many respects, the parameters specific to private wealth investment management mean than a direct application of institutional processes is not feasible. Further, the business model and organizational structure of private banks also needs to evolve, if enhanced investment processes are to be implemented. Several approaches are being currently tried to improve the investment proposition of private wealth management. We propose a revised framework for private wealth investment management, which we believe overcomes some of the challenges organizationally and from an investment standpoint, and allows better management of private wealth assets.

JEL Classification G1, G2

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Institutional investment management has evolved over the years to be a transparent product industry, where competitive pressures have led to greater efficiency in the investment processes, better risk management, lower fees and greater alignment of interest between the asset owner and the asset manager. Private wealth management on the other hand has been driven historically by the need for privacy, legal structures to protect ownership and inter-generational transfer of assets, where the client has a relationship with the individual banker rather than the banking institution. This has led to a less effective investment structure for these assets, where both the client and the banking institution did not consider management of the assets as a prime objective. With the evolution of the private wealth industry to a legal environment where privacy is no longer possible, where global legal structures are more readily available in a cost effective manner and where strength of institutions has become a bigger factor for a banking relationship, the value of the investment proposition of private wealth assets has come into focus. In this paper, we outline the changes that would be necessary in the private wealth investment industry and the challenges therein, for the assets to be managed with a more efficient investment proposition.

The Investment Problem

The requirements of a private client are in reality exactly the same as that of any other kind of asset owner (pension plan, SWF, endowment etc.) – to generate a defined absolute nominal or real return with a constraint on the risk taken. At first glance therefore it would seem that this requirement can be tackled in exactly the same way as a traditional institutional plan sponsor portfolio problem. However there are differences, which make this investment problem more difficult to solve and implement, than an institutional investment problem. These differences are elaborated below.

1. A True Absolute Return requirement

Multi-asset managers managing an institutional or retail product, marketing to deliver an absolute return in a long-only environment, sidestep the issue of constant long market exposure, by creating hybrids of asset class market benchmarks as the yardstick by which they want to be evaluated, rather than a cash benchmark. This then neatly allows them to manage the assets like a relative return portfolio with a long exposure to asset classes (by under or overweighting asset classes, relative to the hybrid benchmark). The mismatch between the required absolute return and the new long hybrid benchmark is left basically unmanaged.

In plan sponsor institutions, which need to deliver an absolute, inflation adjusted or liability based total return, the same problem is sidestepped by creating a “policy portfolio”, which, similar to the commercial asset management world, is used as a tool to transform the absolute return problem of the plan, to a relative return problem which is then followed by managers inside the institution. The risk of having long market exposure, against an absolute return requirement, often is put under the guise of a “long term investment horizon” or left largely unmanaged, at the mercy of market forces. The only exception to this structure is a select group of primarily US endowments, who structurally create an absolute return portfolio for the whole plan, with no constant long market exposure, with the aim of delivering an overall absolute return.

In the private wealth world, where agency issues are lower (given that the assets belong to an individual, who would himself be the decision maker on where to bank his assets), the absolute return requirement comes to the fore. As discretionary mandates give full control of the investment process to the asset manager, the risk 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 is then a true absolute return investment problem, which in reality is more difficult than the institutional investment management problem.

2. Customization

Notwithstanding specific cases, institutional investments mostly follow a common framework, where assets are invested in multiple comingled fund structures – internal or external. Private wealth is however distinguished by the fact that every single client specifies constraints and preferences he wants incorporated into his portfolio. This takes the form of types or limits on investments, liquidity, leverage, single stock holdings, home bias, inter-generational requirements and cash flow. Given the large number of accounts in private wealth, this creates the issue of managing a large scale implementation where all accounts are different in one respect or another, and each will need a different portfolio, even though the manager may have a single market view.

3. Account Size

The asset base in an institutional product evolves slowly as the product gains traction, and as such the investment process can largely be created for a single portfolio size, at any given time, be it a large or small asset base. However, in the private wealth setting, there can be dramatically different sizes of accounts which need to be managed at the same time. As such, the investment process needs to simultaneously be applicable and relevant to extra large and extra small account sizes.

4. Defined Time Horizon

As institutions are going concerns, in general they afford a tolerance for a longer investment horizon to realize their investment objectives. While intra-horizon draw-downs can be painful, the agency structure serves to delink any emotional attachment to the assets, thus decreasing behavioral biases of the asset owner. Private wealth, especially for first generation clients, is very much an emotional attachment of the owner. As such, the tolerance for intra-horizon draw-downs is far less. Despite being financially savvy in running their own businesses, the prospect of emotionally biased decisions at points of drawdown are very real in private wealth. This has 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, while this is possible, it becomes more cumbersome to have this done for every single client account. As such, there is a limitation on 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, larger bid-ask spreads and a management and performance fee for investment products. These multiple levels of fees then create a higher hurdle for private wealth assets to deliver a similar net of fees return compared to institutional assets which don’t have these costs.

7. Direct stock holding

Private clients have a bias for direct holdings of stocks, rather than investment in funds. While this is an emotional bias, it does have some rationale. It is an appropriate proposition to hold a stock directly with the objective of an absolute return, where it is acceptable to have a draw-down, rather than hold it inside a fund where the objective is market relative performance.

Given these differences, a standard institutional investment process cannot be directly ported to solve a private wealth problem. This is often under-appreciated by institutional asset managers.

The Business Model and Organizational Problem

The private wealth business has always been a service oriented model providing not only discrete banking services, but everything from legal facilitation for intergenerational wealth transfer, flexibility of multiple booking domains to villas and yachts. In order to finance these extensive services, the business model of the private banks has been to seek revenue at as many levels as possible from the private client asset base. Apart from fee structures, as discussed above, a critical component of the business model has historically been the inclusion of services from other parts of the bank into the asset structure. The most prominent one of these in the investment framework has been the use of internally managed funds from their own asset management division as a compulsory feature in all assets, and the use of 'favored' external managers in the asset structure, who provide a 'retrocession' to the private bank.

1. Favored use of in-house funds

In an institutional setting, it is unthinkable for an asset owner to contemplate giving more than one or two mandates to a single asset manager. Firstly because it is seldom the case that a single asset management institution has more than two best in class products, and secondly it defies fiduciary logic to have operational and counterparty risk concentrated with one institutional manager. In the private banking world however, the opposite is true. An increasingly large amount of assets of a private account are compulsorily invested in in-house funds, such that the fee revenue accrues to the same institution. This is not only a definitive conflict of interest, but also potentially detrimental to the performance on the private client assets, as in-house funds are favored over superior external funds.

2. Favored External Funds based on retrocession revenues

The issue of retrocession revenues in private wealth is analogous to the use of soft dollars in the institutional asset management industry, where service providers to the asset manager are given business from client assets, in return for a 'kickback' paid to the asset manager. The Myner's Commission Report of 2001 led to the unbundling of broker commissions in the institutional asset management world. The Swiss Supreme Court judgment of 2012 on retrocession revenues has a similar impact on the private banking world, where retrocession revenues are deemed assets of the client and not the private bank, unless previously agreed with the client. Apart from being a drag on performance, the availability of such a structure creates a direct conflict of interest for the management of private wealth assets, when the choice is between a fund which provides greater retrocession revenue to the bank, or better performance to the client.

The institutional world today has well defined rules on use of soft dollars, and this is proposed to be made even stricter by the Financial Conduct Authority (FCA) of the UK in its consultation paper of November 2013. In private wealth, any limits on use of retrocession revenues, is yet to be discussed or formalized. While private banks now need consent from clients to allow retrocession, no one governs today what retrocession revenues can be spent on by the private bank. There seems to be no reason why these should not be examined and governed in a similar manner to the institutional world.

3. Trading Costs (Revenues)

In an institutional setting, the trading desk is always an agent with generally no principal interest in the transactions carried out on client assets. Nor is it in the interest of the trading desk to charge higher fees, as agency traders in an asset manager are generally not profit centers, but service providers to the investment manager. In a private bank setting however, trading desks are almost always considered as revenue generators and in some cases even profit centers. This incentivizes greater misalignment with the client's objectives, and has multiple impacts on a private wealth portfolio. First, it incentivizes the relationship manager (RM) and trading desk to churn the portfolio, a practice that is illegal by SEC regulations on the institutional side. Second, the private bank trading desk often charges commission to the client, over and above the commission charged by a trade executing investment bank – this is done either explicitly as a transaction fee, or worse as a undisclosed spread on buy and sell transactions. These fees are most evident in fx transactions. These charges inevitably create a much higher hurdle for delivering performance on private wealth assets.

4. The Relationship manager – Investment manager dichotomy

The historic service orientation of the private wealth business made the RM a focal point, acting as the point man providing client service, the investment manager of client assets, and managing the conflict between the client's return requirement and the bank's revenue requirement. In contrast, the organization structure of institutional asset managers is aligned with the objective of delivering investment performance. However, as the focus on investment performance of private wealth assets has increased, private banks now find themselves with a need to evolve their business model, in order to implement an institutional quality investment framework on private wealth assets.

Private banks choosing to identify themselves with a service and distribution business model, are transferring investment decision authority from the RM to a separate investment team created from the backbone of the erstwhile institutional asset management team. Here, RMs are focused on client service, and prevented from taking investment decisions, which are either taken by the client (in an advisory structure) or taken by the investment team. Other banks choosing to distinguish themselves as private wealth asset managers are creating investment teams within the private bank, often at the expense of the institutional asset management business. In either model, the result is to design and implement investment processes with an institutional quality skill, while incorporating the challenging parameters and solution flexibility that private wealth requires.

Private Banks attempting to run both an institutional asset management business and a private wealth business face the greatest challenge. This is especially acute in cases where the asset management business depends to a great extent in sourcing assets from the private bank for its livelihood. Such a business structure is likely to be detrimental both for private wealth clients (to get customized service from institutional asset managers) and to institutional clients (as often the majority of assets in institutional funds are actually not sourced by competitive mandate wins, but by captive private wealth assets, who tend to be less stringent on investment processes). Unless the asset management business can stand independently on its own, without the crutch of the private bank assets, it is likely to be a poor investment proposition for both private and institutional clients.

Incumbent Investment Frameworks

The standard investment solution for private wealth assets has been based on the concept of a 60/40 balanced portfolio, with some variations. Variation in the risk level of the portfolio to cater for the asset owner's risk aversion led to conservative and aggressive portfolio solutions. The need to fulfill periodic liabilities led to an income oriented portfolio. Incorporation of the finite earning life of an individual led to the development of life cycle funds, where the proportion of equity risk taken in the portfolio is decreased as an individual becomes older. Incorporation of a retirement date for the individual or of specific future liabilities led to the development of target date funds.

A dimension where investment managers have sought to differentiate themselves has been in the process followed for the equity-bond allocation decision. Similar to the debate on active versus passive management, there are institutions which believe that a static allocation structure (like the 60/40) is best, and other which advocate an active process for the allocation of assets. A third category that has been created recently is those that shun active asset allocation as a philosophy, yet use risk parity or risk factor allocation as an allocation philosophy. Idzorek and Kowara (2013) however caution that the claims made by these managers of superiority are unwarranted, and seem more a marketing strategy than formed by investment substance.

However, the biggest challenge faced by private banks is organizational. While the structure has facilitated client service, it has been largely poor at investment management. An improvement of investment performance requires the transfer of investment authority from the RM to specialist investment staff. Conversely, it is also true that institutional asset managers often underestimate the customization and client service element of managing private wealth assets. Hence while private bankers are poor at managing assets, institutional asset managers are poor at customized client service and large scale customized portfolios. Herein lies the biggest structural challenge. Several implementation approaches have been tried to resolve this problem –

1. A Core-Satellite Portfolio Structure

A core satellite portfolio can be created for each client, where the RMs are instructed to invest the broad core of any account into a standard core investment product, with the remainder satellite being managed by the RM at the wishes of the client or at his discretion. The core is then managed by a professional investment team. This sidesteps the issue of asset managers being required to do extensive client servicing, and yet creates investment robustness at least for the core of the portfolio. The drawback of this approach is that a large business risk exists on the performance of the core investment product. If the core underperforms, as it surely will during a performance cycle at some point in time, all client portfolios across the bank will suffer, which presents a business risk to the firm. Further, it limits the level of customization that can be done for clients, as a standard core will present the same investment solution for all clients. Constraints such as a large home bias, or lack of certain asset classes or geographies will be difficult to meet.

2. Core Packaged set of internal funds

Here, a core set of in-house investment products are bundled into a package for investing in all accounts. This is similar to the core-satellite structure, except that the core is a basket of internally managed investment products. While this facilitates better client customization, it leads to a more detrimental overall structure for the client. Every bank has a defined set of “good” out-performing products, which don’t change very often. These will happen to be in specific asset classes, where the investment team of that asset class in this firm has good skill, and will vary from firm to firm. Allocation of assets to these products should first and foremost be done if the asset class is attractive in the coming period, as the private client requires an absolute return. Markets will not always favor investing in these asset classes all the time. However, if this structure was chosen for a private client, it would almost certainly force the firm to allocate to those asset classes where the firm has good products. This may lead to better alpha return, but can be much more detrimental to the overall portfolio return as the beta of those asset classes may be a poor investment.

3. A Top-down House View

A top down house allocation view can be defined, which is then used by RMs to construct each individual portfolio. This method has high flexibility for client customization, however as the allocation implementation process is left to the individual RM, he can choose to disregard the house view and implement his own view. This deviation is not always possible to be monitored or governed, and hence will create disparate client portfolio, where the house view may or may not be reflected.

A Revised Investment Framework

An investment framework for private wealth need to cater explicitly for two facets –

(a) investment decisions made by specialized investment staff, rather than RMs

(b) an implementation framework which can be customized to client requirements

Consider a private wealth platform structure in a private bank, where professional money managers make available their full portfolio for investment by private clients. These ‘model portfolios’ are replicas of the institutional fund that they would manage, and updated on a live basis like a custodial account. All investment decisions on these model portfolios are taken by investment managers. Clients have the ability to invest in the institutional fund share class of a chosen manager, or directly in the underlying assets of the fund in an unconstrained manner through the platform. The fees would be the same, so the manager and firm should be largely indifferent on the implementation choice. If the client does not specify any customization or constraints, the client portfolio would be rebalanced automatically as the institutional portfolio is. If the client chooses to define constraints, then the client rebalance would be modified by these constraints. Allocation to different asset classes can be done in a similar manner, although Gupta (2014) advocates how the institutional asset allocation process itself needs to evolve from where it is today. As both in-house and externally managed funds would be on the platform, the bias towards in-house funds would be reduced.

There will of course be specific products where portfolio holding replication is not feasible. For example hedge funds and illiquid funds, would be required to be held as comingled funds, and fixed income direct holding may only be possible for sizeable accounts (as minimum ticket sizes per bond are higher). Or indeed, in asset classes where the client believes he wants to ‘set and forget’, he may prefer to have the fund holding rather than stock rebalances. However this structure solves a number of critical issues, present in the incumbent structures –

(a) It creates a fully customizable investment structure, where the client can define any constraint. This is not possible to such an extent in either the core-satellite or the in-house fund structure

(b) It facilitates direct stock holdings for the private client, which is often a requirement

(c) It retains the financial revenue base for the firm, as the same fee that is charged for management of a comingled fund, and can be charged for the provision of the model portfolio.

(d) It allows all investment decisions to be taken by professional money managers (except where the client defines preferences) which should improve the investment results. Yet it retains the implementation control to a limited extent with the RM, which should result in less disruption of incumbent organizational structures.

(e) It provides a service where separate private bank teams for advisory services and discretionary services are not required. Effectively, the portfolio is the same, and the level of client decision making (advisory) is up to him.

This structure is present already as managed accounts in institutional asset management, where subject to minimum asset size, individual accounts are created, as demanded by large institutions. In the alternatives world, the platform structure has come into focus in order to provide greater transparency to the client on his portfolio, which enables better risk management. There seems to be sufficient reasons, why this structure should also find traction in private wealth asset management.

Conclusions

Private wealth is one of the largest asset bases in the world, which till date has not had a specific focus on delivering investment returns. With the changes underway in the industry, forcing transparency of private wealth, and the realization that the services provided by private banks are very similar to one another, greater emphasis is now underway on the investment performance of these assets.

Investment processes followed by private wealth need to improve to deliver better performance and risk management, but in a manner where customization and service quality are not compromised. This requires current structures, both on the institutional asset management and the private wealth asset management to evolve and embrace the specific and different requirements of this asset base.

We propose here a potential solution, which would satisfy the requirements that are normally specified by private clients for their assets, while creating portfolio that has institutional strength investment decision making. As it has minimal organizational disruption impact, we believe this structure to be a potential option for private banks to consider, as they reorganize their structures, to deal with the new investment challenges.

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