

# Research for Business

London - Nice - Singapore



# Surveying Private Wealth Management Practices in Europe

*London-Zürich-Luxembourg, September 28<sup>th</sup>-30<sup>th</sup>, 2010*

Felix Goltz, PhD.

Head of Applied Research, EDHEC-Risk Institute

David Schröder, PhD.

Research Associate, EDHEC-Risk Institute

[research@edhec-risk.com](mailto:research@edhec-risk.com)

# Outline

- The EDHEC-Risk Survey
  - Insights from the field
  - A representative sample
- Key results
  - Limited value-added in conventional concepts
  - Investment advice falls short of true customisation.
  - Investors' time horizons are key but incoherencies remain.
  - Private Asset Liability remains little used.
  - Priorities for future improvements

# Outline

- **The EDHEC-Risk Survey**
  - Insights from the field
  - A representative sample
- **Key results**
  - Limited value-added in conventional methods and concepts
  - Investment advice falls short of true customisation.
  - Investors' time horizons are key but incoherencies remain.
  - Private Asset Liability remains little used.
  - Priorities for future improvements

# The EDHEC-Risk Survey

## *Private Wealth Management Practices in Europe*

- **A snapshot of current industry practices**
  - 159 questionnaires (March to May 2010)
  - 14 in-depth interviews (May and June 2010, in Amsterdam, Geneva, London, Luxembourg, Monaco, Paris, Sofia, Utrecht, and Zurich)
  - The survey mainly focuses on portfolio and risk management aspects of PWM rather than tax/legal advice.
- **Client relation and client objectives:**
  - Where do PWMs perceive they add value?
  - What are clients' most important objectives?
  - What are the relevant risk factors clients are exposed to?
- **Implementing investment decisions for private clients**
  - How is the client's asset allocation defined?
  - Which methods or concepts are used?
  - Which parameters are taken into account in the investment process (background income, client objectives, time horizon etc.)?

# The EDHEC-Risk Survey

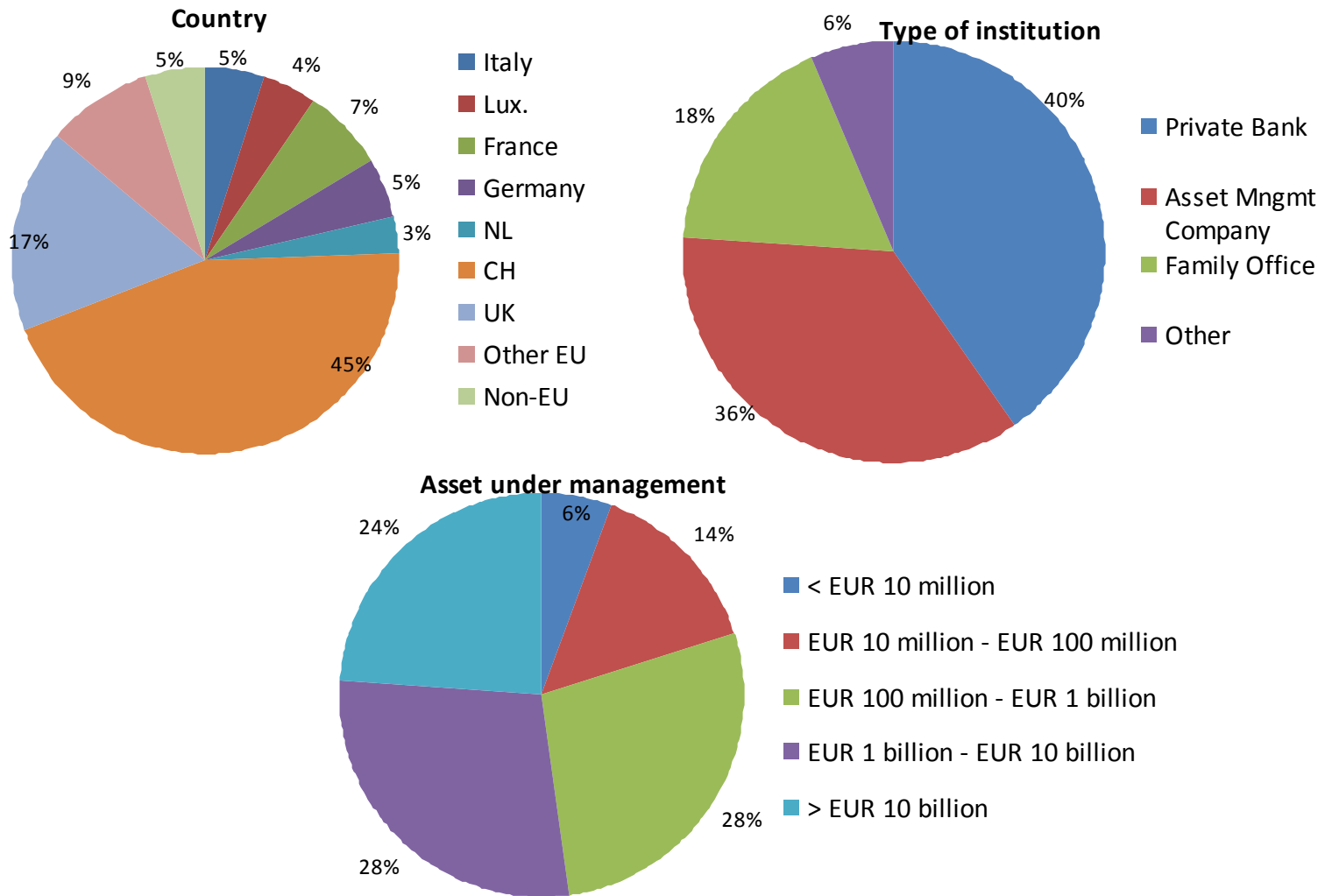
## *Private Wealth Management Practices in Europe*

Our survey of European private wealth managers promises to provide unique insights:

- There is no comprehensive evidence to date on how investment strategies in private wealth management are designed, how client objectives are taken into account and what role the various financial methods and concepts play in the investment process.
- A detailed analysis of results allows assessing to what extent the knowledge created through academic research spreads to practice.
- Survey results will provide a useful benchmark for wealth managers that wish to compare their practices to their peers.

# The EDHEC-Risk Survey

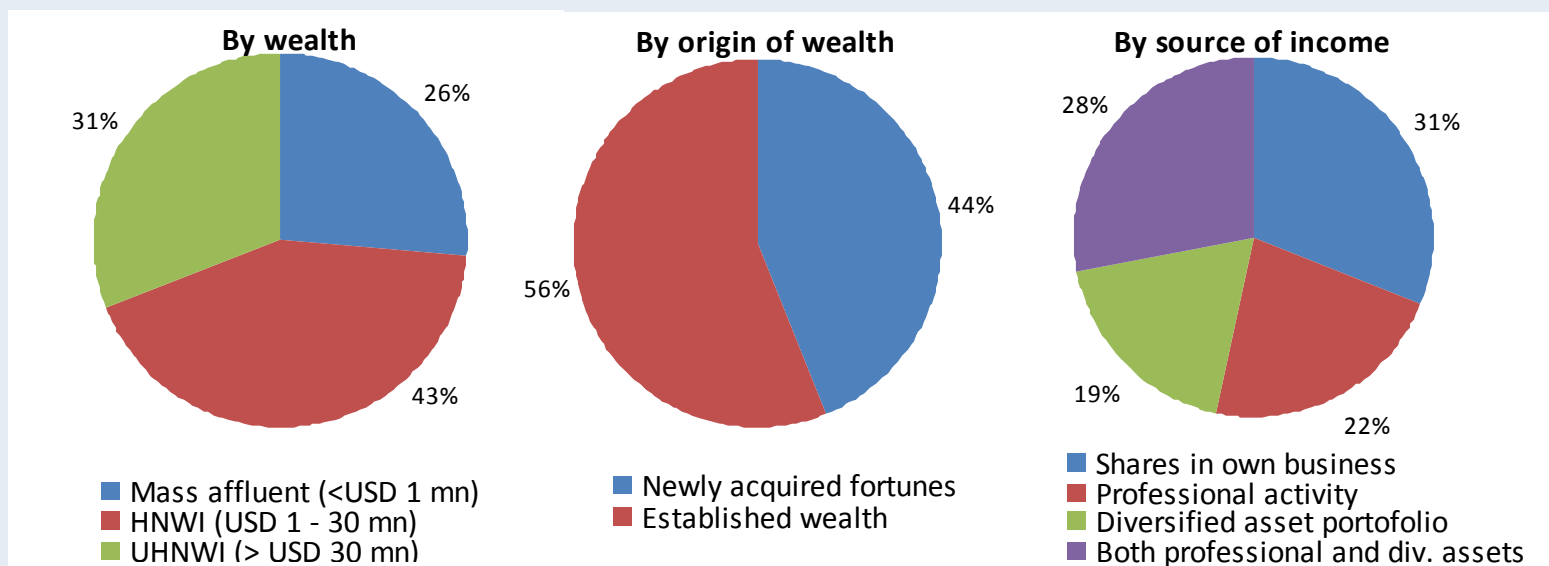
*A representative survey of 159 professionals*



# The EDHEC-Risk Survey

*A representative survey of 159 professionals*

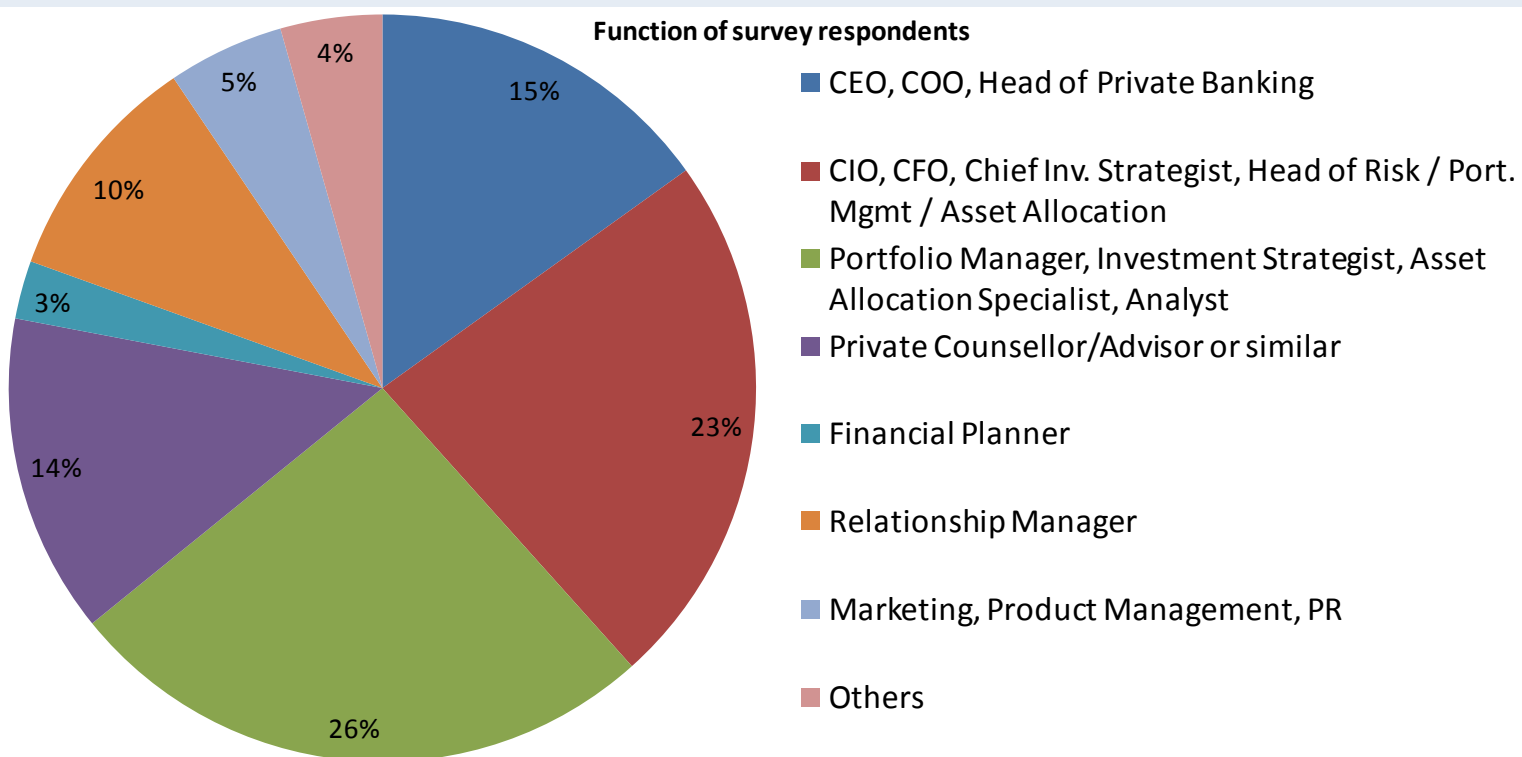
- Average breakdown of clients of respondent firms:



# The EDHEC-Risk Survey

*A representative survey of 159 professionals*

- **Breakdown of respondent s' role within their firm:**



# Outline

- The EDHEC-Risk Survey
  - Insights from the field
  - A representative sample
- **Key results**
  - Limited value-added in conventional methods and concepts.
  - Investment advice falls short of true customisation.
  - Investors' time horizons are key but incoherencies remain.
  - Private Asset Liability remains little used.
  - Priorities for future improvements

# Evaluation of methods and concepts

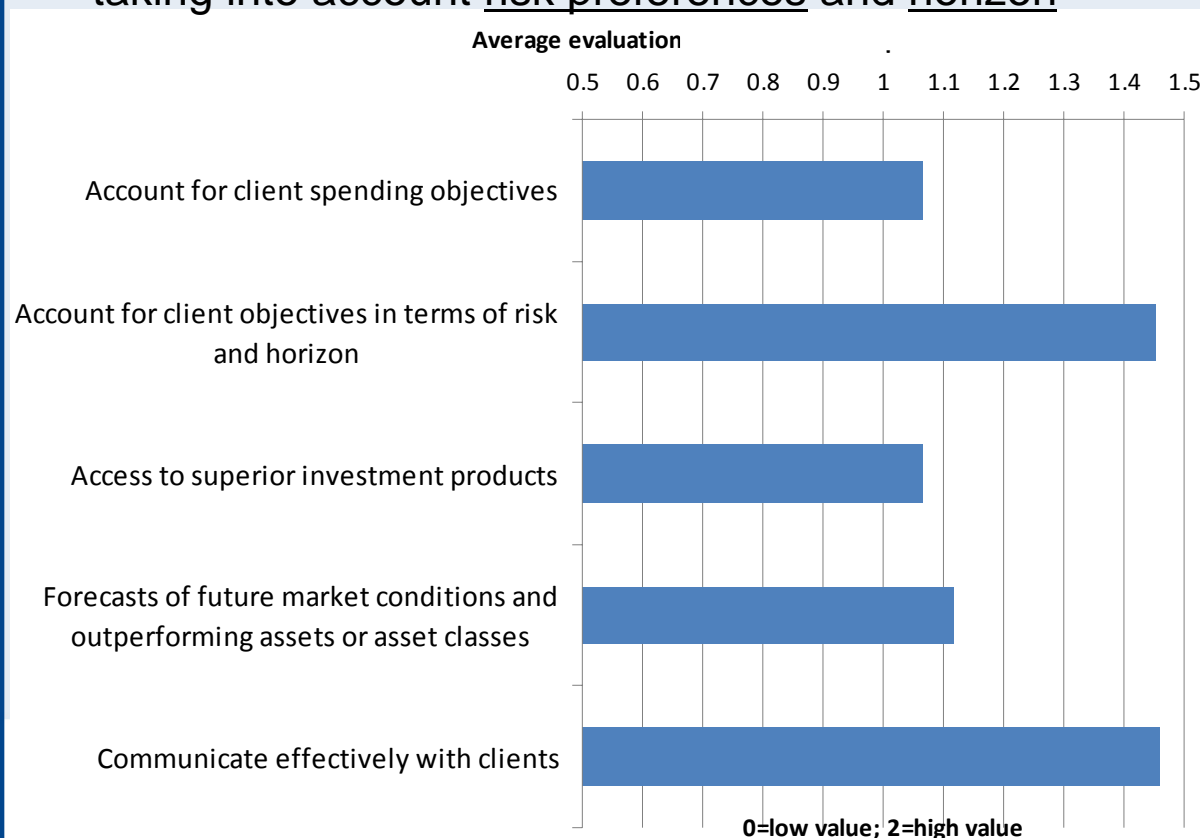
## *Investment Management Concepts: Mean Variance and Beyond*

- We asked PWMs how much value they see in various methods and concepts that lie behind investment practice and that are often related to results of academic research.
  - *Mean-variance portfolio analysis*
  - *Black-Litterman (1992) allocation model.*
  - *Asset liability management (ALM)*
  - *Goal-based allocation*
  - *Life cycle investment*
  - *Portfolio insurance*
  - *Dynamic allocation*
  - *Dynamic risk budgeting*
  - *Fundamental analysis*
  - *Macroeconomic analysis*
  - *Due diligence on funds or fund managers*
  - *Performance evaluation*

# Evaluation of methods and concepts

## *Average evaluation with respect to different objectives*

- We first show the average evaluation of all concepts with respect to different objectives they help to attain.
- PWMs consider that available concepts add value for communication and taking into account risk preferences and horizon

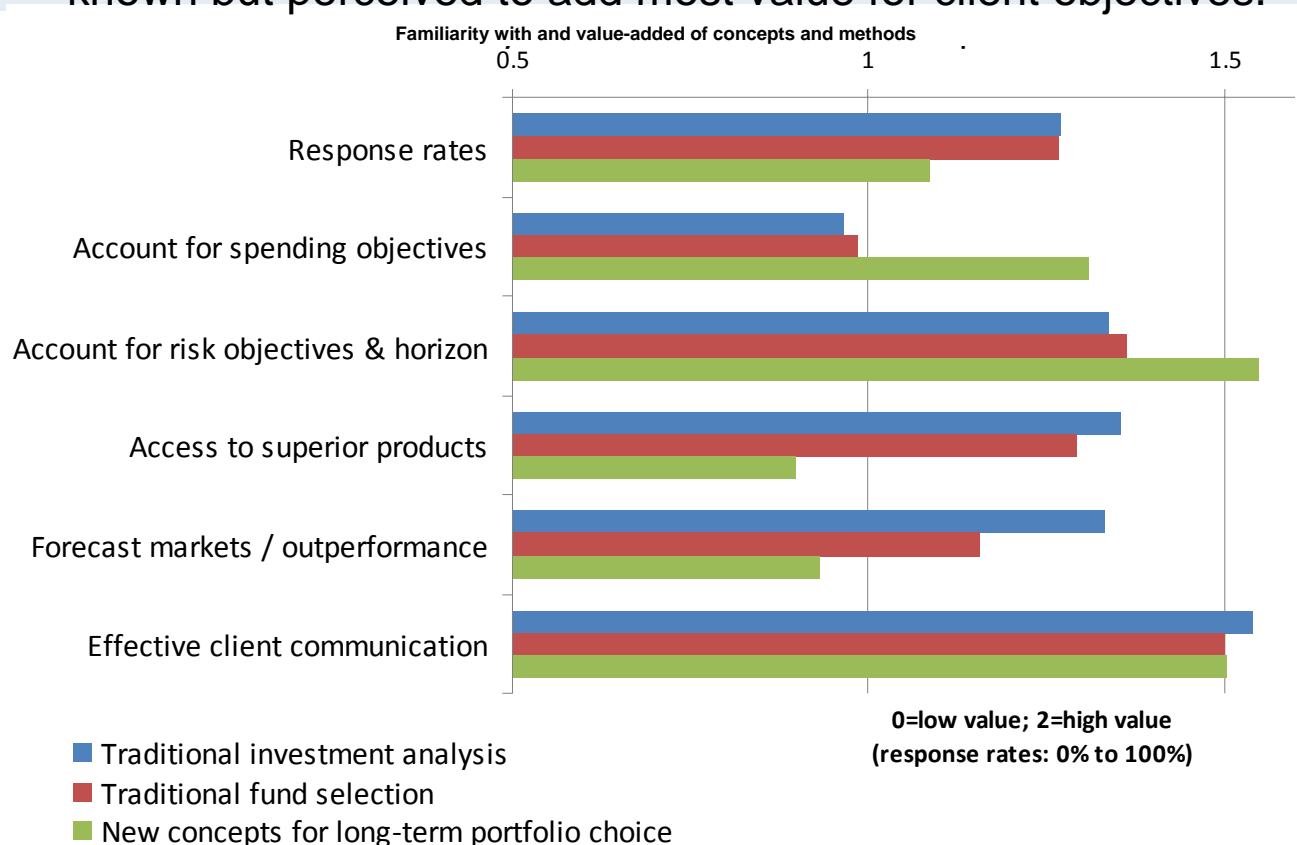


- Concepts are ranked least favourable with respect to addressing client spending objectives, and with respect to out-performance generation

# Evaluation of methods and concepts

## *Traditional versus new concepts*

- Traditional methods and concepts are most widely known but perceived as adding least value for client objectives!
- New concepts from long term portfolio choice (ALM, life cycle) are less known but perceived to add most value for client objectives.



- Long term portfolio choice: ALM, life cycle
- Traditional investment analysis: fundamental and macroeconomic analysis
- Traditional fund selection: due diligence, performance evaluation

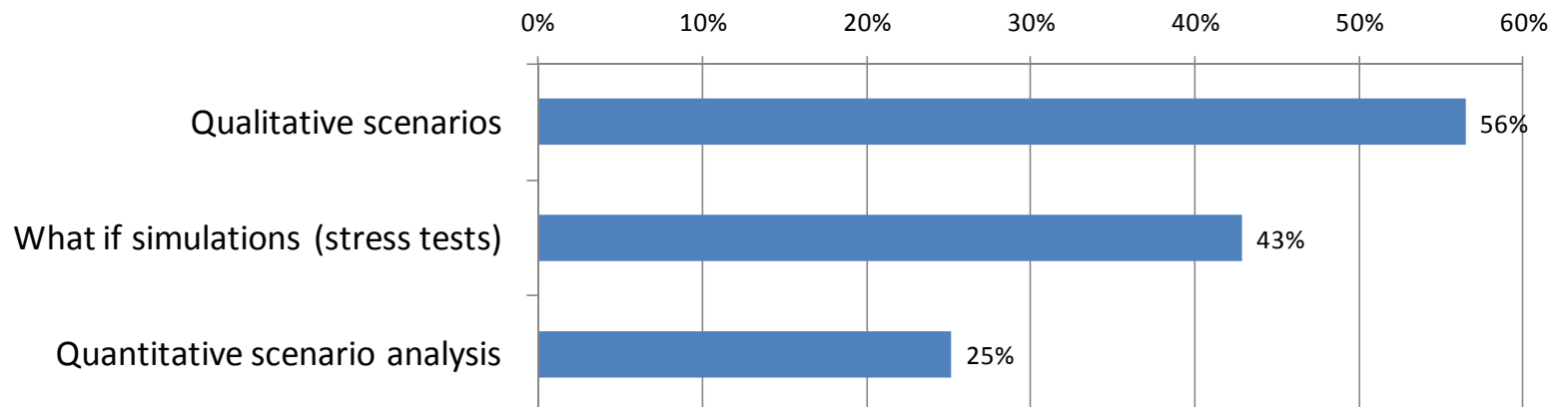
# Evaluation of methods and concepts

## *Scenario Generation*

- Qualitative scenarios dominate. These have the advantage of being intuitive but they only give a limited range of outcomes.
- Only about 16% of respondents actually carry out a two-pronged approach combining both qualitative and quantitative analysis

### How do you assess the robustness of a specific allocation model ?

Percentage of respondents



# Evaluation of methods and concepts

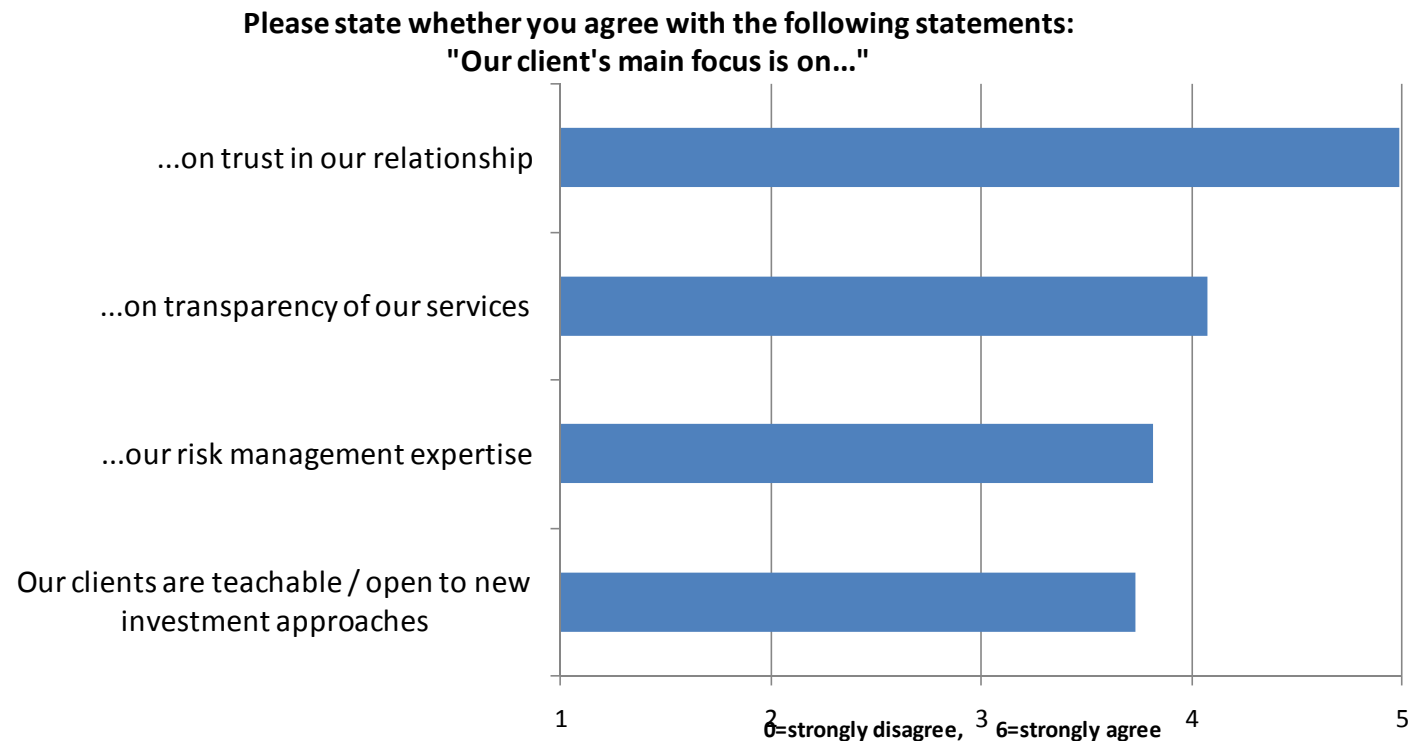
## Main results

- Dominance of qualitative and traditional concepts
  - Respondents clearly perceive a limited value-added in such conventional methods and concepts
  - A main perceived drawback is the lack of being able to address specific client objectives
- An interesting question is to see how knowledge about such client objectives is translated into investment decisions (next section)

# Client Relations vs. Customized Risk Management

## Main focus of clients

- PWMs think that clients turn to them mostly to seek a trusted relationship, and are less motivated by searching risk management expertise.
- Transparency is a further key issue, especially following the 2007/2008 crisis.



# Client Relations vs. Customized Risk Management

## *Perceived Sources of Value Added*

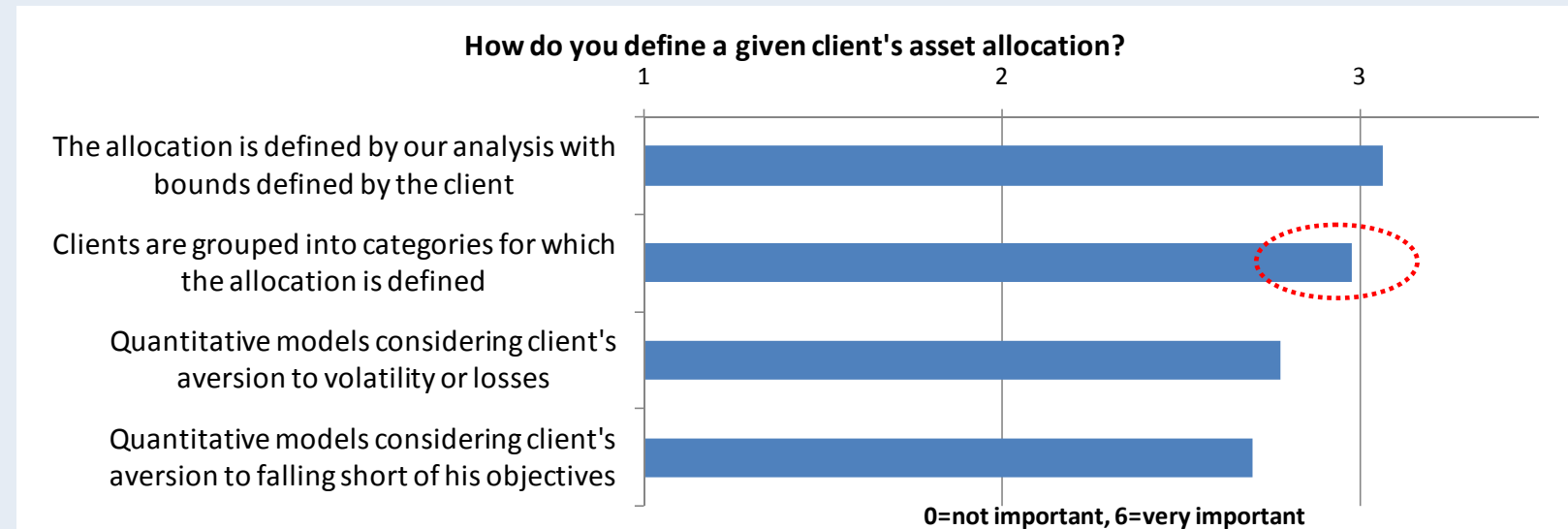
- A more detailed question reveals that client relations in the broad sense are what PWMs perceive as their main value added.



# Client Relations vs. Customized Risk Management

## *Defining Asset Allocations*

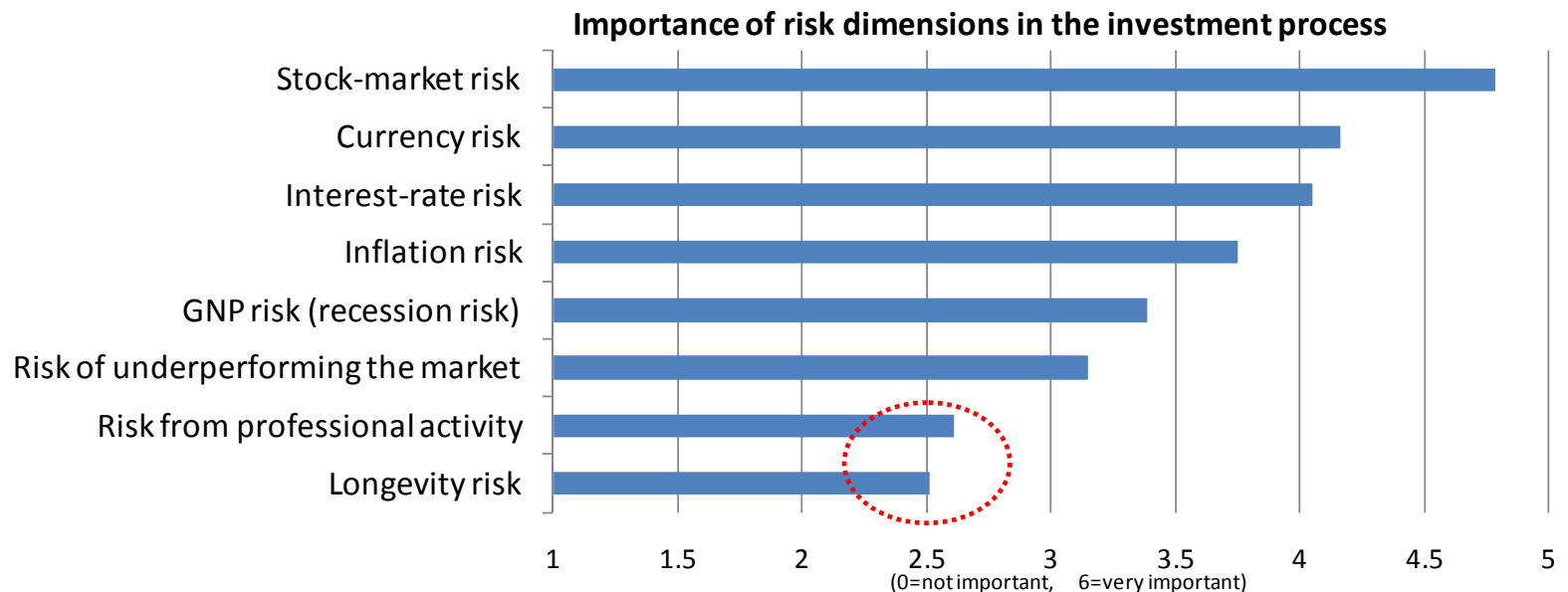
- Practices sometimes similar to retail (lifestyle) funds. Asset allocations are simply defined by categories.
- General risk measures (i.e. volatility) are more important than client specific risk measures (i.e. falling short of objectives)
- Direct allocation decisions in the form of constraints are left to clients themselves.



# Client Relations vs. Customized Risk Management

## Market factors and individual factors

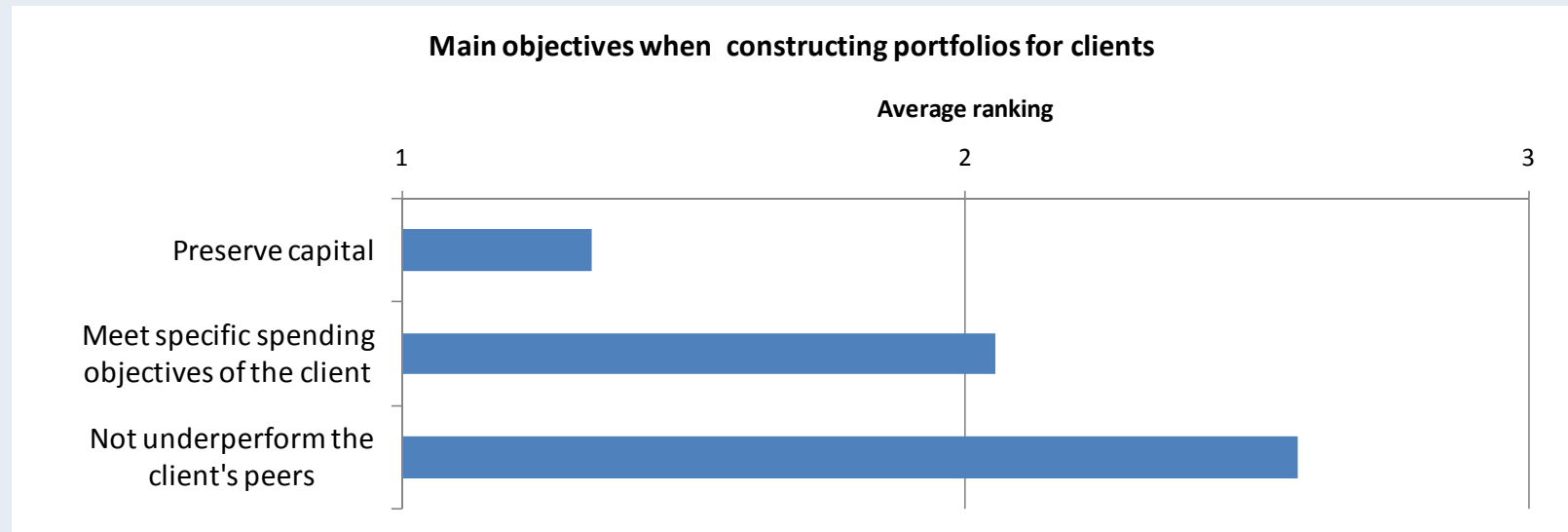
- Market factors such as equity, currency, interest rate, inflation factors are seen as most important.
- Among market factors, equity risk dominates, despite the high importance of inflation and interest rate risk in the portfolio choice literature.
- Individual factors are seen as less important, suggesting that PWM's detailed knowledge of the client is finally little used.



# Client Relations vs. Customized Risk Management

## Absolute Returns?

- Capital preservation is the main focus that is taken into account when PWMs construct client portfolios.
- This is of course fully consistent with expressed client preferences.
- However, a focus on capital preservation does not necessarily require deep knowledge of the client and is to some degree similar to generic absolute returns funds.

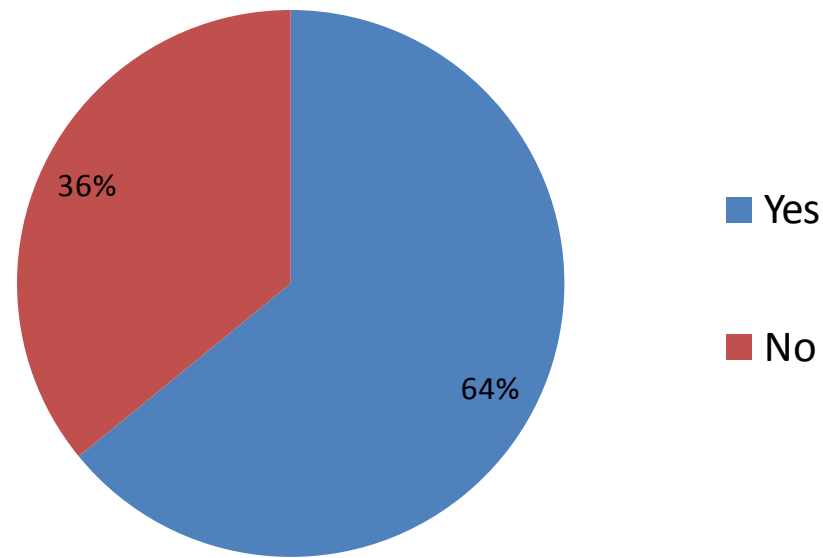


# Client Relations vs. Customized Risk Management

## *Income risk*

- Viciera (2001) and Cairns et al. (2006) underline that correlation between salary and asset returns is an important determinant for portfolio allocations.
- More generally, the source of (outside) income matters for the allocation decision among financial assets.
- However, most respondents do not consider explicitly the income source of their clients.

Do you account for the nature of the client's background income?



# Client Relations vs. Customized Risk Management

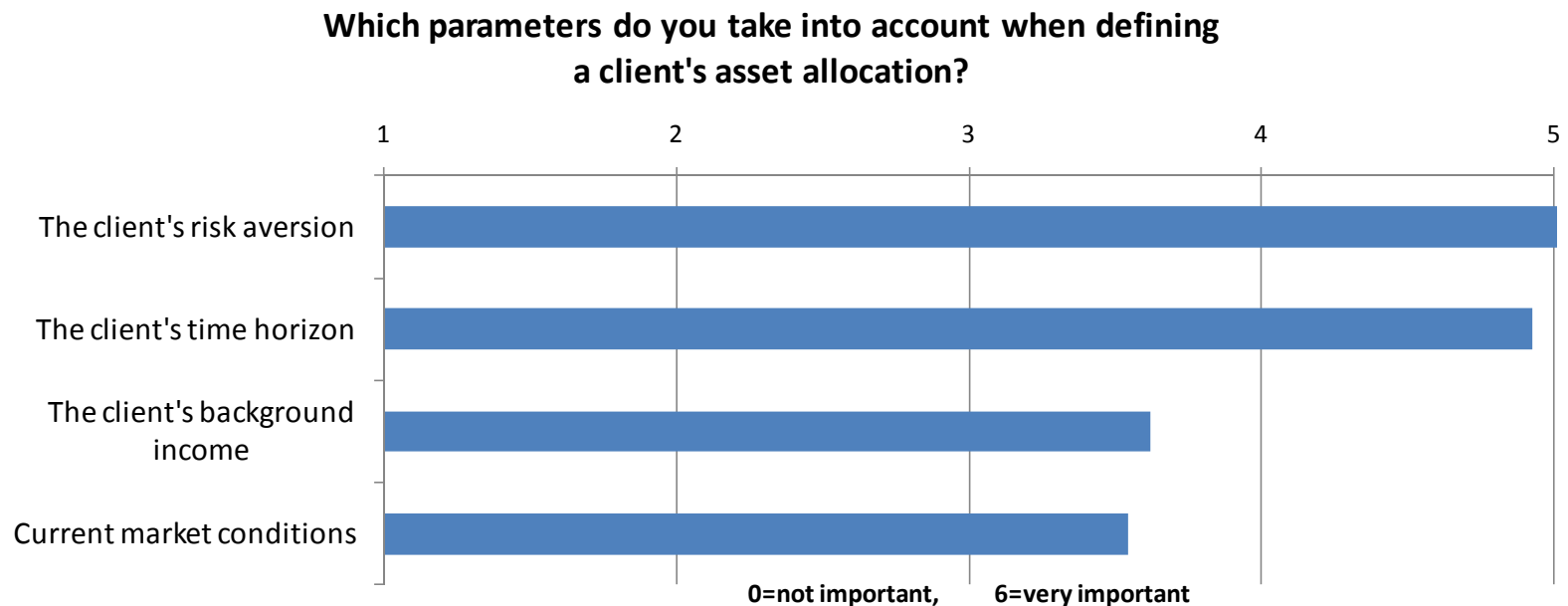
## Main results

- Knowledge about client specific objectives is little used in constructing portfolios
  - Of course, this does not mean that PWMs do not spend significant efforts of knowing their clients and taking into account e.g. their tax situation and risk aversion
  - However, from a financial risk management perspective, truly tailored solutions are little used.
- A key factor for respondents however is taking into account the client's time horizon. How this is done is assessed in further detail below

# Accounting for clients' investment horizon

## *Importance of parameters in asset allocation*

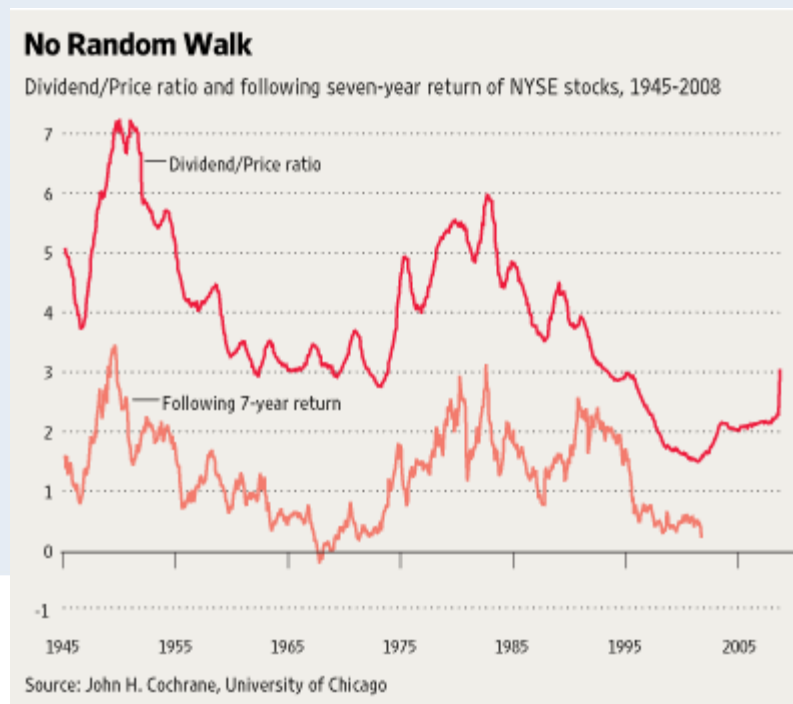
- The investment horizon is key factor in designing client portfolios in practice, second only to risk aversion.



# Accounting for clients' investment horizon

## *Mean reversion: a stylised fact in securities markets*

- The presence of **mean-reverting** equity volatility and risk premium induce revisions in the strategic asset allocation.
- For example, the equity risk premium can be related to variables such as Price / Earnings ratio or Dividend Yield (Campbell and Viceira 1999).

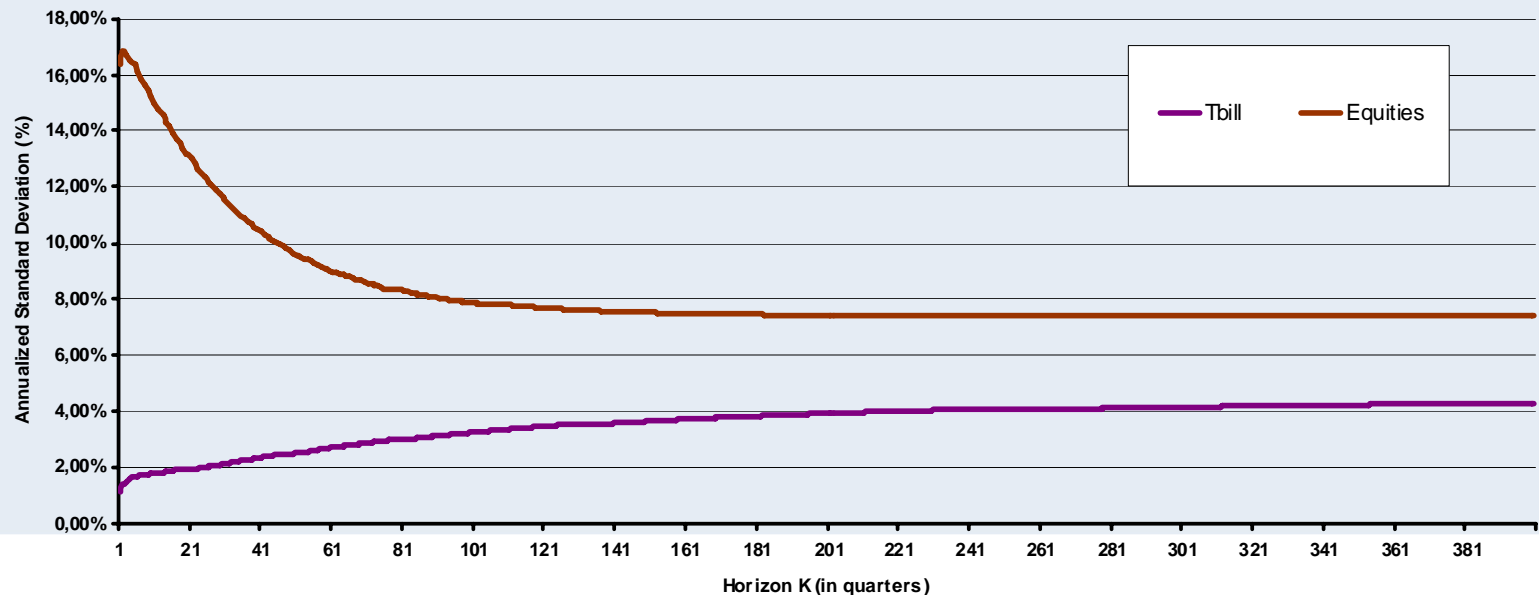


# Accounting for clients' investment horizon

## *Mean reversion leads to horizon effects*

- Long-horizon returns on stocks are significantly less volatile than their short-horizon returns because of mean-reversion
- Hence equity allocation should be higher in early stages.

Figure 1. Annualized Percent Standard Deviations of Real Returns Implied by Quarterly VAR(1) Estimates (1952.Q-2002.Q4)



Source: Campbell and Viceira 2005

# Accounting for clients' investment horizon

*Mean reversion leads to revisions of strategic allocation*

Viceira (2007):

*“Research suggests that long-term equity investors should invest more on average in equities than their short-horizon counterparts, but they should also consider periodic revisions of this allocation as market conditions change.”*

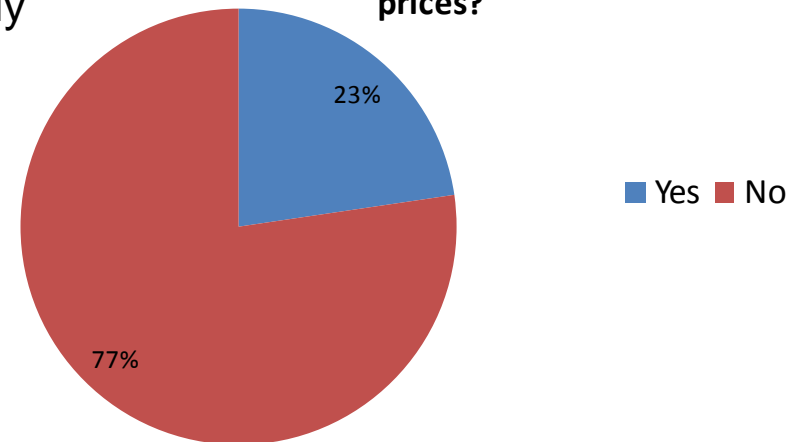
*“It is logically inconsistent to count on reduced long-term risk while ignoring the variation in returns that produces it.”*

# Accounting for clients' investment horizon

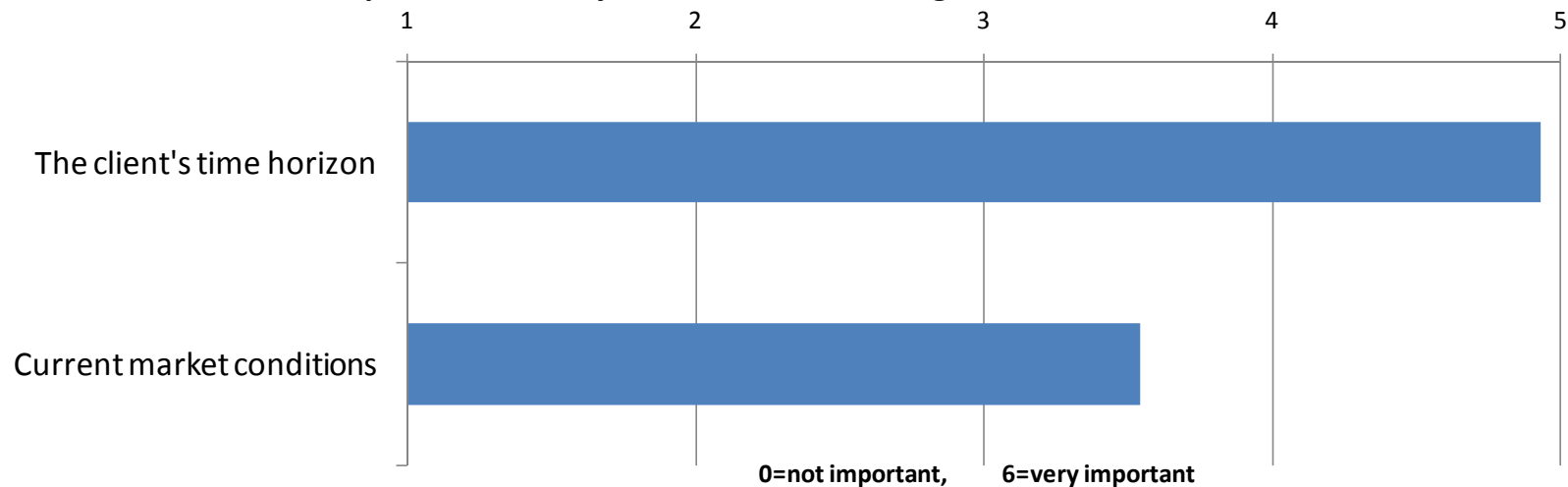
## *Time horizon and market conditions*

- Current market conditions are accounted for much less frequently than time horizon.
- Mean reversion is typically not explicitly modeled.
- This suggests that to a certain degree “logically inconsistent” practices are being used

Do you use a long run market model for stock prices?



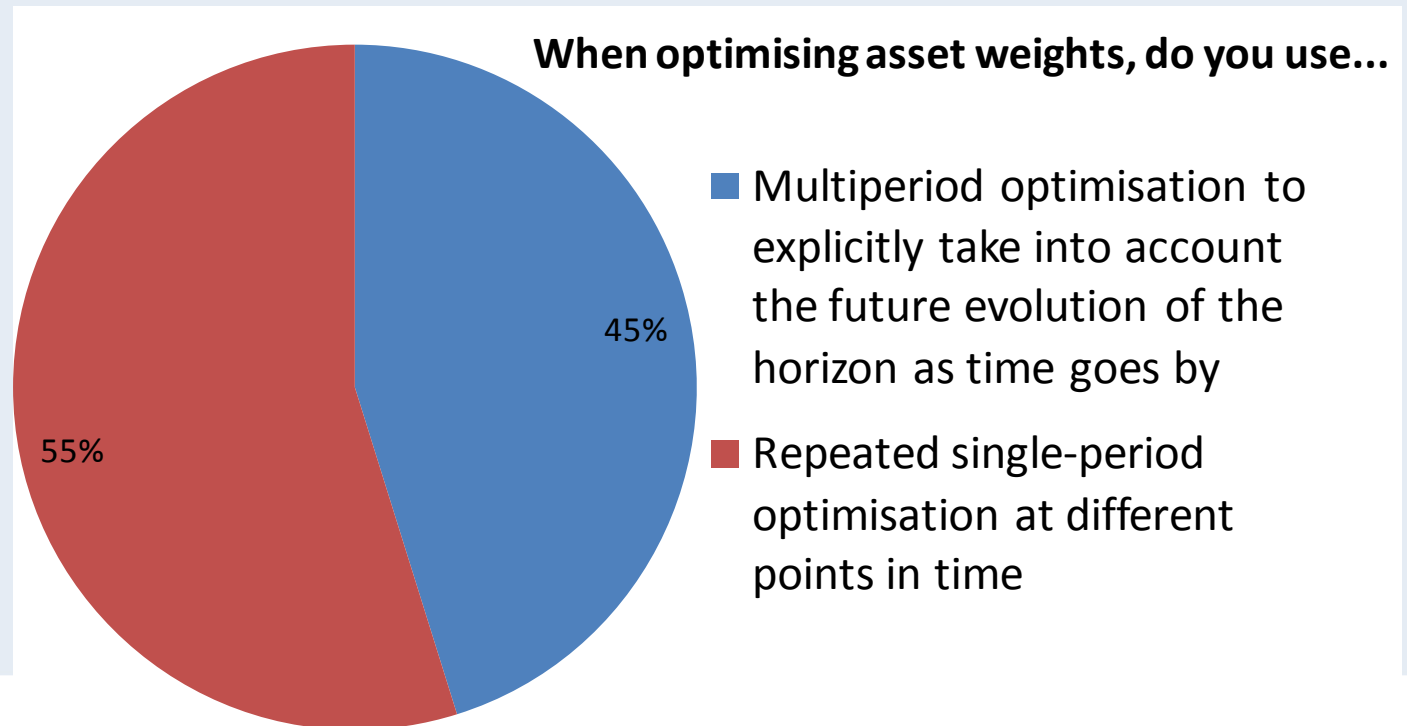
Which parameters do you take when defining a client's asset allocation?



# Accounting for clients' investment horizon

## *Multi-period optimisation*

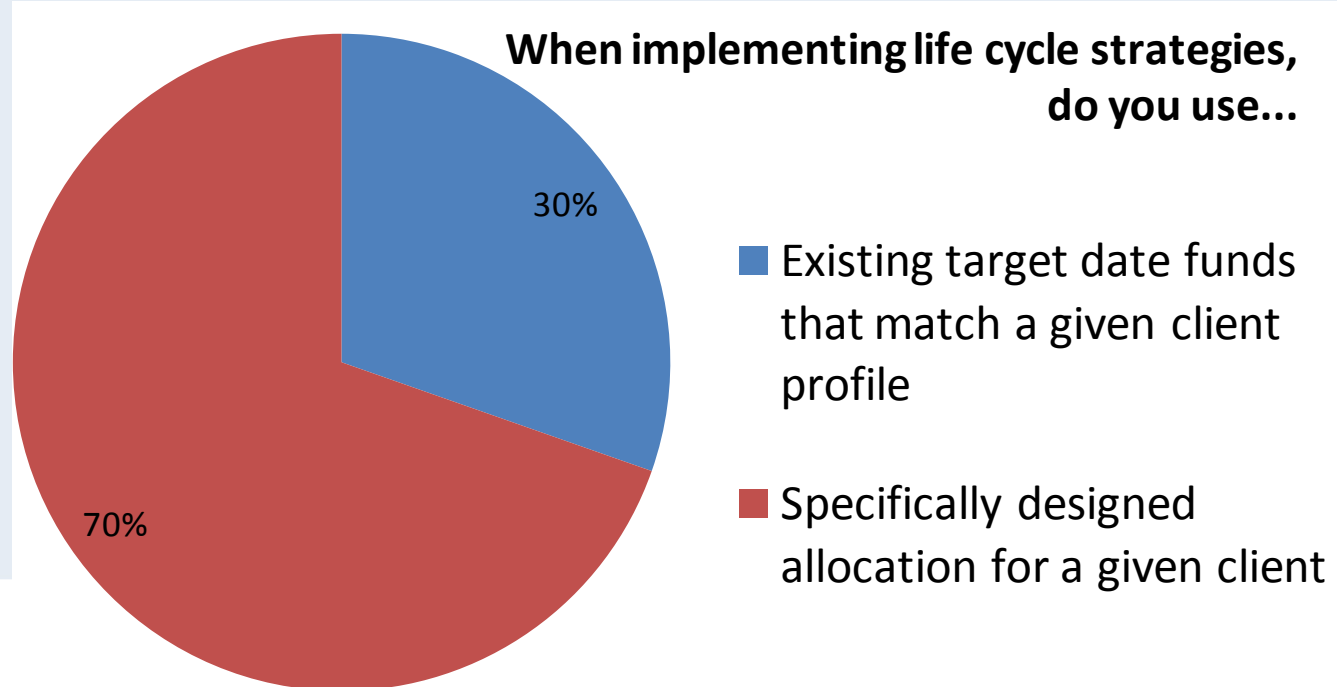
- Multi-period optimisation takes into account changes in investment opportunities and the ability to react at the next decision making date.
- Repeated single period optimisation is “myopic” and can only be justified in rather “artificial” conditions.



# Accounting for clients' investment horizon

## *Target date funds*

- Existing target date funds are widely used. This again suggests that customisation is not applied by all PWMs.
- The main motivation for using custom lifecycle allocations may be to account for investors' risk aversion rather than taking into account other specific factors or market conditions.



# Accounting for clients' investment horizon

## Main results

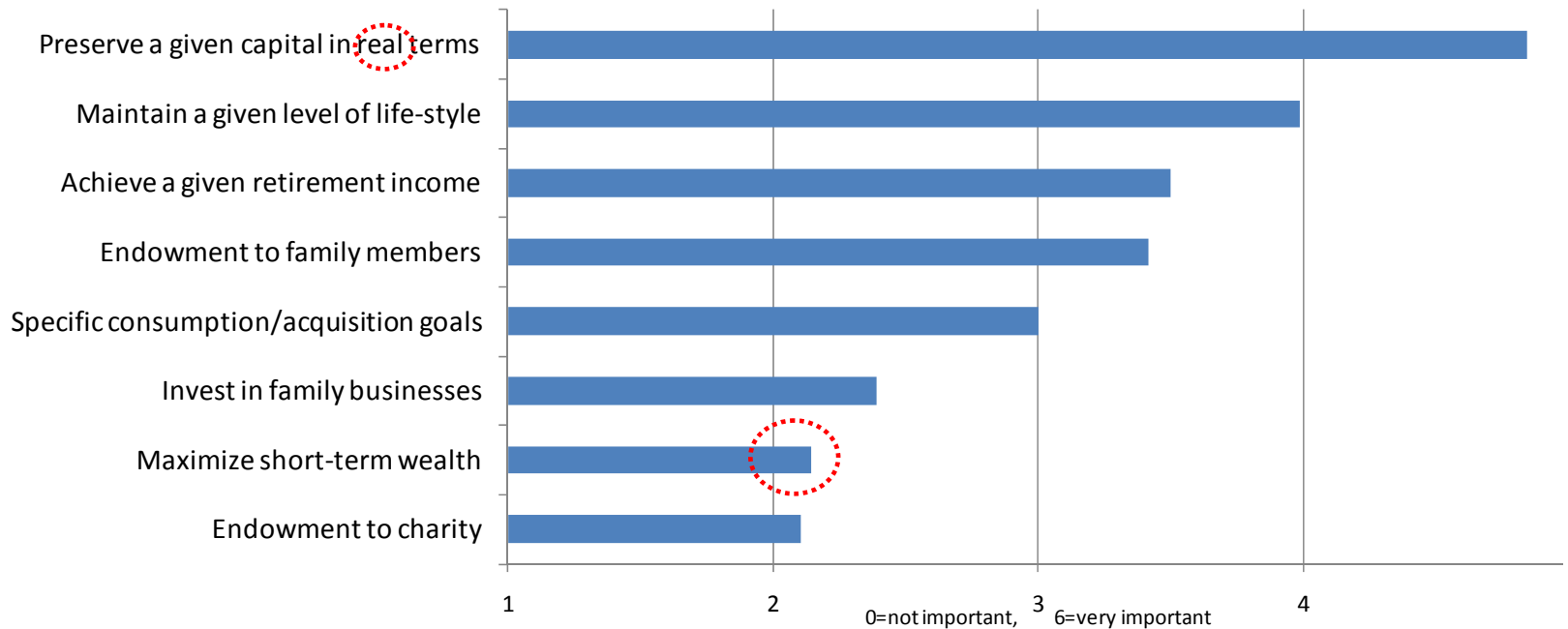
- The investor's time horizon is seen as a crucial factor in PWM
  - However, it is often accounted for in an inconsistent manner.
  - The mean reverting mechanism behind horizon effects is rarely taken into account (through revisions of strategic asset allocation that would be necessary)
  - Off the shelf solutions such as target date funds are widely used instead of customised solutions.
- The time horizon is intimately linked to goals that clients want to achieve. Managing assets relative to such objectives is discussed below.

# Asset Liability Management

## *Client goals*

- PWMs understand the inflation/consumption related goals of their clients.
- They see such goals, as more important than wealth maximisation per se.
- Preserving a real capital refers to *general* inflation but *specific* targets are also important (level of lifestyle, specific acquisition goals)
- Tools that allow addressing these concerns are thus of prime importance.

Please indicate what importance you believe the following objectives have to your clients



# Asset Liability Management

## *Client goals*

- When analysing differences between advisors who mainly advise UHNWIs versus other advisors, differences in client goals emerge
- However, despite a common conception, our survey results suggest that even the most wealthy clients typically have concrete spending objectives.

*Client objectives perceived by UHNWI advisors versus advisors of less wealthy*

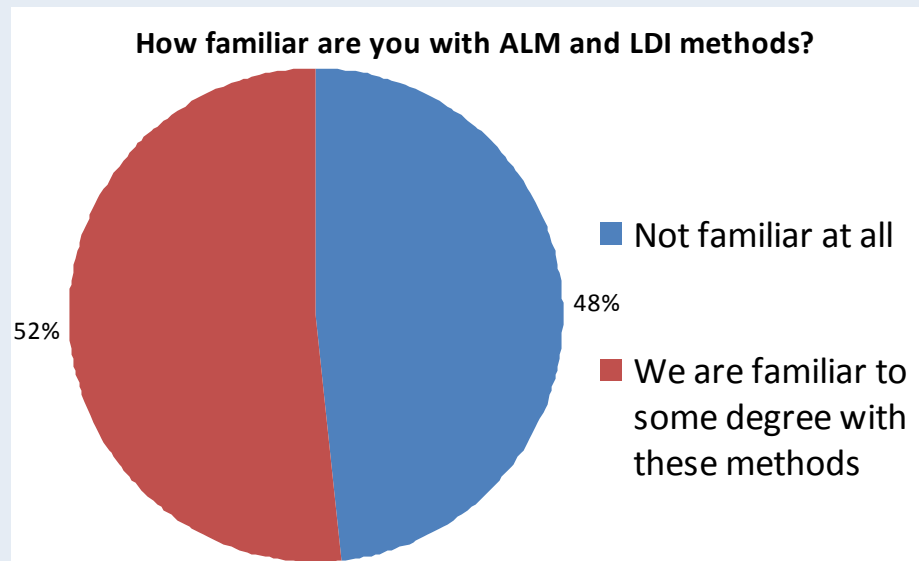
	Advisors of UHNWIs (avg. score)	Other advisors (avg. score)	Difference in average score
Maximizing short-term wealth	1.48	2.39	<b>-0.92</b>
Achieving a stream of consumption goals	2.68	3.12	<b>-0.44</b>
Securing a retirement income	2.66	3.81	<b>-1.15</b>
Investments in family businesses	2.90	2.20	<b>0.70</b>
Provision of endowments to foundations	3.02	1.73	<b>1.30</b>

These differences are statistically significant as assessed by using a Mann Whitney test

# Asset Liability Management

## *ALM knowledge of respondents*

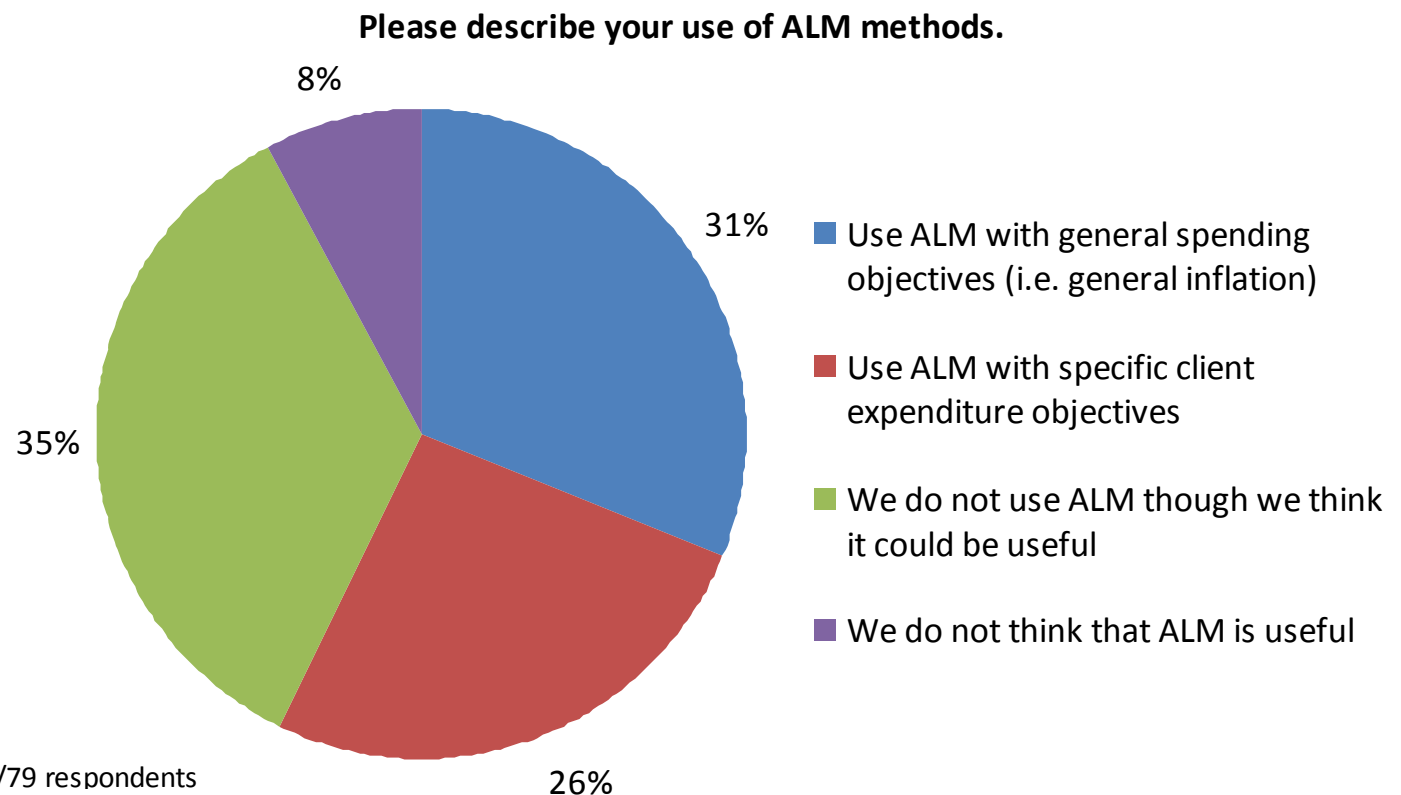
- Given that ALM and LDI emanated from institutional investment management, familiarity with the approach is actually fairly high among PWMs. More than 50% of respondents know about such approaches.
- It is of interest to analyse the views and practices of those respondents who do know about ALM in more detail.



# Asset Liability Management

## *Potential for increased use in the future (I)*

- Among those with some knowledge of ALM, refraining to use the approach is not explained by a negative opinion on ALM. 35% of those who know ALM see its use but do not employ it!
- Among ALM users, *general* rather than *specific* objectives dominate.

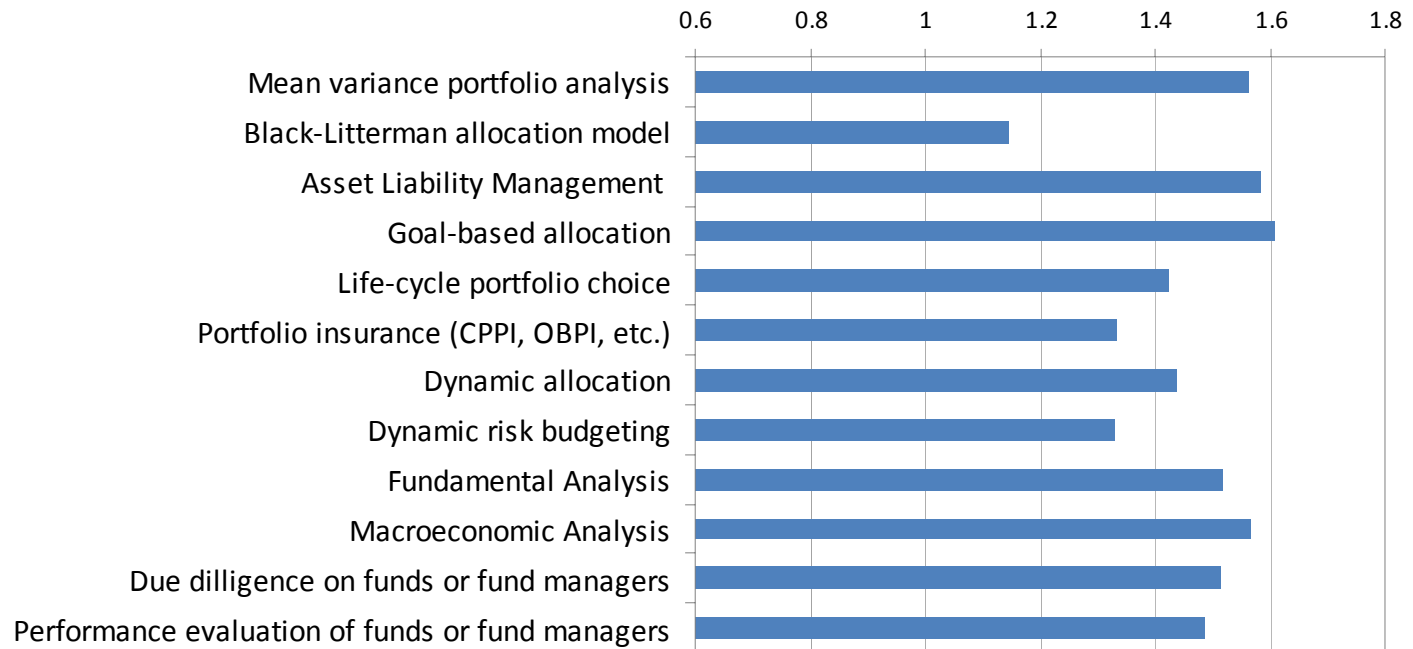


# Asset Liability Management

## *Potential for increased use in the future (II)*

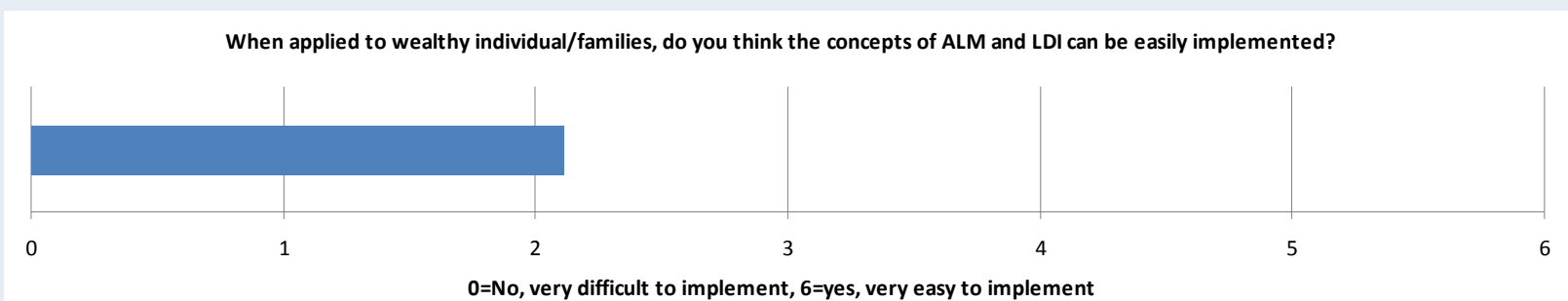
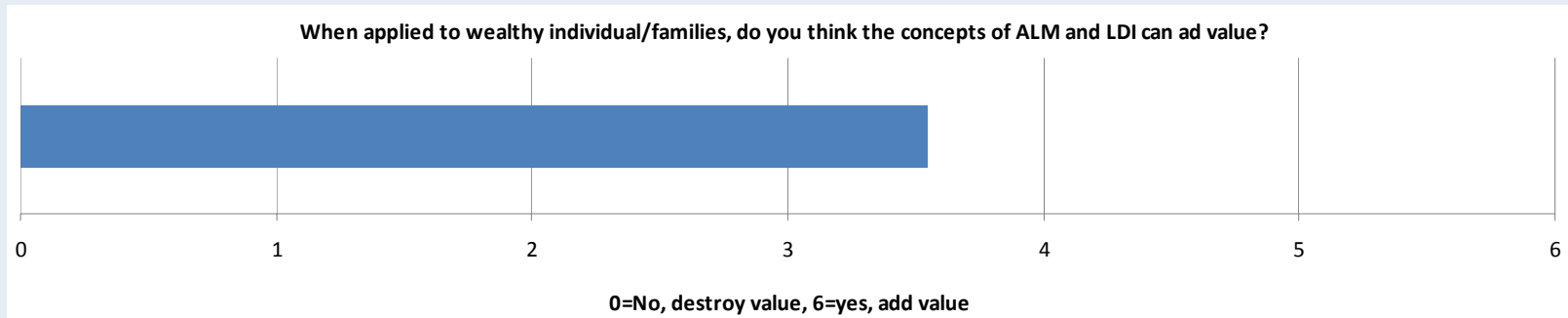
- ALM is seen as a most useful concept for client communication
- This may be explained by the fact that despite complex techniques involved, the basic notion of ALM corresponds to how clients think about management of their wealth.

### Evaluation concerning effective communication with clients



# Asset Liability Management Implementation hurdles

- We asked respondents whether ALM strategies could actually be implemented for the benefit of their clients



- Detailed interviews reveal that PWM face challenges by
  - client's reluctance to disclose their situation
  - difficult access to hedging vehicles for very specific hedging demands
  - Lack of familiarity with institutional ALM techniques
  - difficulty to measure client liabilities

# Asset Liability Management

## Main results

- ALM is natural tool for PWM: Clients and advisors naturally think in terms of ALM
- However, there seem to be implementation hurdles.
- In particular, there is a lack of practical tools for PWMs to implement such techniques
- ALM is seen as a source of progress for the future of PWM

# Conclusion

## Differences in implementation of customized risk management

### *Differences of asset allocation practices depending on income source of clients*

Importance with which PWMs take into account...	Advisors of professionals (avg.score)	Advisors of non-professionals (average score)	Difference in average score
...detailed spending objectives	3.72	3.27	0.45
...current market conditions	3.85	3.26	0.59
...background income	3.88	3.40	0.48

- Advisors who mainly have clients with a professional income source, seem to design more specific asset allocations.
- This could be a sign that customisation is more important for such clients or that such clients are more demanding in general.

# Conclusion

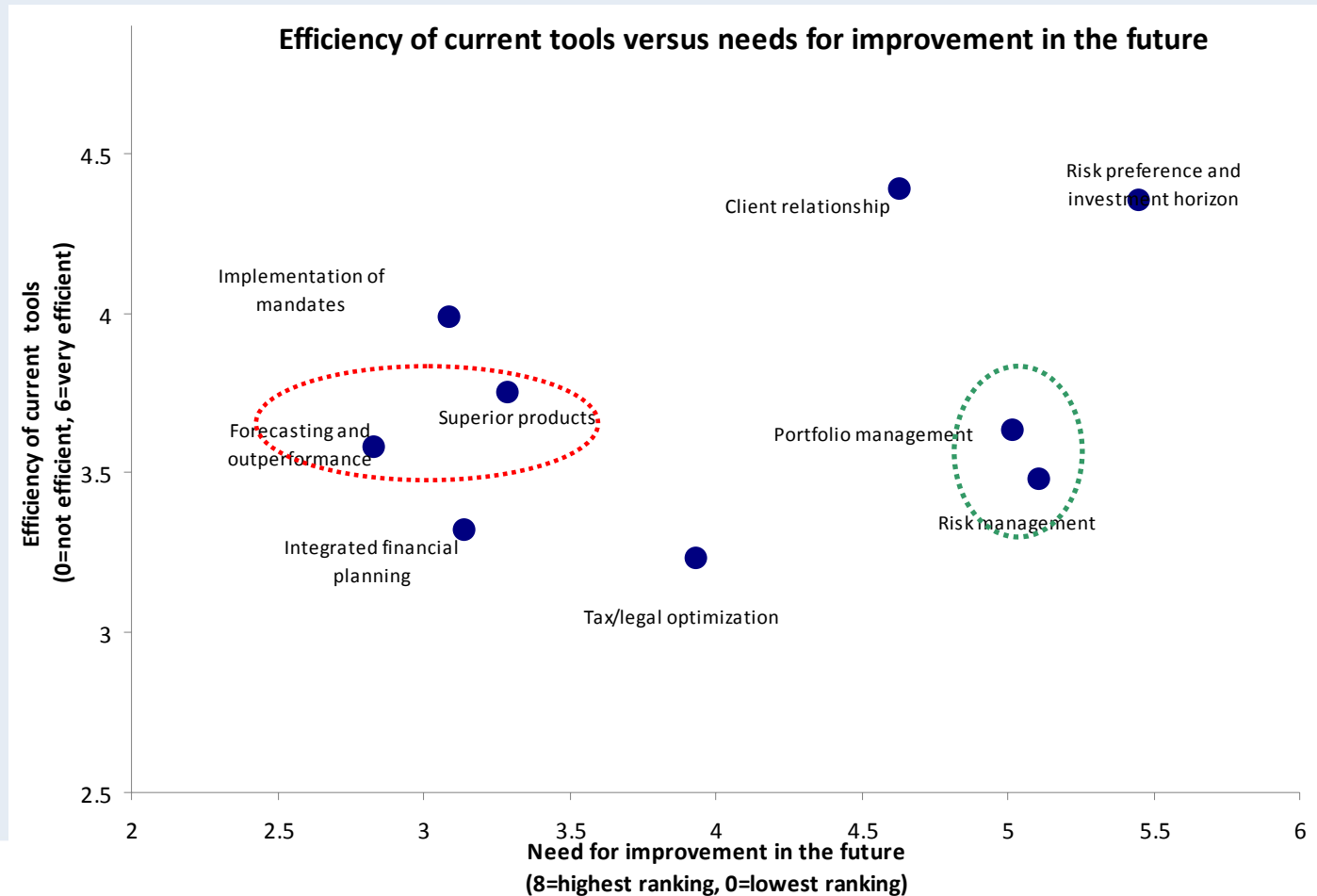
## Possible evolutions of practices



- Respondents are dissatisfied with methods and concepts in terms of access to outperformance and superior products, but improving the situation is not a priority for them (i.e. there is not much hope of improvement).
- Customised risk management and taking into account investor preferences rank highest on the list of future improvements

# Conclusion

## Current efficiency vs. priorities improvements



# Conclusion

## Possible evolutions of practices

- Our representative sample of European PWMs allows us to gain new insights about the state of the industry:
- A look at current practice reveals that:
  - Good tax and legal optimisation are much accomplished in current practice.
  - In terms of customised risk management, respondents see limited value-added in conventional concepts
  - Investment advice falls short of true customisation.
  - Investors' time horizons are key but incoherencies remain.
  - Private Asset Liability remains little used.
- Respondents' priorities for future improvements:
  - Customised risk management and taking into account investor preferences rank highest on the list of future improvements
  - Detailed interviews reveal that the concepts are perceived as difficult to implement but despite the implementational challenges, there is a realistic potential of making clients benefit from tools that have a sound conceptual base

# References

Bodie, Zvi, Robert C. Merton, and William Samuelson (1992): Labor Supply Flexibility and Portfolio Choice in a Life-Cycle Model, *Journal of Economic Dynamics and Control* 16 (3-4), pp. 427-449.

Cairns, Andrew J. G, David Blake and Kevin Dowd (2006): Stochastic lifestyling: Optimal dynamic asset allocation for defined contribution pension plans, *Journal of Economic Dynamics and Control*, 30(5), pp. 843-877.

Campbell, J. Y. and L. M. Viceira (2002): *Strategic asset allocation*. Oxford University Press.

Viceira, Luis M. (2001): Optimal Portfolio Choice for Long-Horizon Investors with Nontradable Labor Income, *Journal of Finance* 56(2), pp. 433-470.

Viceira, Luis M. (2007): Life-cycle funds. Harvard Business School, working paper.

Campbell and Shiller (1998): Valuation Ratios and the Long-Run Stock Market Outlook. *Journal of Portfolio Management* 28(2), pp. 11-26.