PRIVATE BANKING INVESTMENT TRENDS IN 2006 AND PERSPECTIVES FOR 2007

Equity appetite dominates as private banks eye hybrids

With an increased appetite for risk, equity was the favoured asset class by private banks in 2006 in spite of the market correction in May. For the coming year, Maxime Jouret of BNP Paribas' Retail Platform believes that private banking clients will look to cross-asset products in their quest for outperformance

Private banking investment trends in 2006 were once again dominated by private investors' appetite for equities and risk.

Private banking clients, in a nutshell, are very sensitive to high coupons or expected returns. This search for high yield or performance from private investors has a direct impact on their portfolio asset allocation. That is why, in today's low rate environment, quite a large proportion of private investors' portfolios is invested in equities or so-called equity-linked instruments. This trend can mainly be observed in on-shore private banks with, for example, in the UK a broad equity-driven investment culture. In fixed income markets, private clients have tended to invest in fixed-rate instruments with high absolute coupons, while institutional clients have been much more active in variable-rate structures, the main feature of which being the spread over a benchmark.

The second significant difference in behaviour between a private and an institutional investor is their market timing. Thanks to the various processes and tools in place in a bank, asset manager or hedge fund, institutional investors often enter a market before private clients. In a specific year, this time lag between the two types of investors can result in different or even opposite investment decisions at any given date.

Finally, since private clients invest in products that are accessible to them in their private bank and because every distributor is looking for an optimal return on assets, the final decision might be influenced by the global marketing strategy of some private banks to focus their commercial effort on products offering distribution fees.

> **"WITH GOOD PERFORMANCE IN EQUITY MARKETS, PRIVATE INVESTORS CONTINUED TO INVEST MASSIVE VOLUMES IN CASH EQUITY, EQUITY FUNDS AND EQUITY DERIVATIVES THROUGHOUT THE YEAR"**

Because of the differences in behaviour described above and experienced by many private banks, private clients have on a global basis during 2006 demonstrated specific investment behaviour different to that of institutional players.

A YEAR FOCUSED ON EQUITY-LINKED INVESTMENTS

Equities were the best-performing asset class in 2006, as in 2005. Private investors' appetite for equities and risk therefore remained robust until the spring. After the market correction experienced in May due to the resurgence of fears of an economic downturn and of new inflation pressures, the markets eventually picked up with the US central bank's decision to stop interest rate rises. In parallel to this positive trend in major equity indices, private investors again increased their exposure to the global equity asset class.

In this context of good performance in equity markets, private investors continued to invest massive volumes in cash equity, equity funds and equity derivative products throughout the year.

In terms of cash equity, most of the private banks we have interviewed saw their trading volumes increase dramatically in 2006. Principal markets on which private investors in Europe have invested are major European markets, often on large capitalisations. For offshore clients, in Switzerland for example, US markets have also represented a significant part of the volumes traded since the reference currency of the accounts booked there is often US dollar. Regarding Asian and emerging stock markets, direct investments have been less frequent because of a lack of visibility from private investors, in parallel sometimes with a lack of in-house broad and dedicated research competencies from private banks on these markets.

The emerging market theme has therefore often been accessed via mutual funds or structured products. All the private banks we have questioned on this topic saw a strong increase of net cash inflows in emerging market funds specialised in Eastern Asia, Great China or Brazil.

Apart from emerging markets, numerous private bank clients have taken an exposure to so-called absolute return funds in order to achieve a positive and non-benchmarked performance of the assets invested via cash, bond or equity investments.

Mutual funds, by giving the client access to some markets or management styles which are difficult to replicate via pure cash equity investments, and by offering distributors running annual distribution fees, have seen their volumes increase significantly in the private banking industry. Most of the private banks have in parallel increased their dedicated teams in charge of in-house and external fund marketing.

As for equity mutual funds, structured products with equity underlyings were in strong demand from private banks and retail distributors in 2006. These instruments offer comfortable distribution margins to intermediaries and also allow private investors to invest in areas for which a direct investment would prove to be complex for low visibility or liquidity reasons. Structured products also enable investors to benefit from a capital-guarantee feature to provide a low-risk profile investment with exposure to equity or commodity products for which prices continued to rise, but fluctuated wildly in 2006.

In the UK and more generally in Europe, three major trends can be highlighted for 2006 as far as equity derivative products are concerned. The first one has been the investment in structured products linked to commodities with very large volumes traded at the beginning of the year. The second noticeable trend is the massive investment in standard structures such as reverse convertibles or athena products, linked to one or more indices or baskets of stocks. By investing in a reverse convertible, the investor receives a high coupon but takes the risk to be redeemed in underlying shares if their performance is below a certain level.

For athena products, the investor receives a high coupon linked to the performance of the underlying. Should the underlying over-perform a strike level at any observation date, the product terminates early and returns 100 per cent of the capital. At maturity, as long as the value of the underlying is above a pre-defined percentage of the initial level, the capital is totally protected. Otherwise, invested capital is reduced one-for-one with any fall in the underlying. Finally, the third major trend has been the investment in structures giving access with capital protection to new underlyings such as Chinese or emerging markets stocks or real estate indices.

A PICK-UP IN FOREX STRUCTURED NOTES VOLUMES

In terms of currencies, the market experienced two major trends: the weakening of the US dollar and the continued weakness of the yen.

In currency derivatives, one of the major themes played this year by private banks has been emerging market baskets, including BRICs, based for instance on views on Brazilian real, Russian ruble, India rupee or Chinese renmimbi. This has reflected the bullish mood in the market on these strong emerging currencies. One of the most popular strategies in the past 12 months has been the use of carry baskets or baskets of high yield emerging market currencies against the US dollar. At BNP Paribas, we decided to take this trend one step further by doing digitals on emerging market currency baskets, thereby giving clients a much higher risk/return. Baskets of emerging market currencies have been particularly popular in some private banks, where speculative clients were looking for structured products with similar pay-offs to equity products.

Numerous private banks also invested in short-dated non-capital protected structured notes allowing speculative investors with a particularly strong view on two emerging market currencies to take an exposure on these currencies' performance against US dollar and potentially to obtain a better return than traditional money market instruments. Some private banking clients for instance believed that Turkey new lira and Brazilian real would remain stable or appreciate against US dollar. These clients were willing to take the risk of not getting a coupon or their full capital back in exchange for a very high reward.

Some private banks also invested large amounts in 2006 in a Forex product designed specifically for bullish investors on the emerging currencies, but unsure of exactly how to distribute their investment. The investors hence purchased FX structured notes which pay the return of the best of three baskets of global emerging currencies, each basket based on a region.

Finally, some private banks looked at very similar structures to a credit first-to-default product, but using forex underlyings. As long as none of the currencies in the basket had 'defaulted', the note would continue to pay a high rate of interest. In this case, the default was a depreciated trigger amount.

A QUIET YEAR FOR CASH BONDS AND INTEREST RATE STRUCTURED NOTES

While US long-term interest rates finished the year around the levels already observed in January, credit spreads have continued to tighten. In this particular context, private investors have not been very active and have proved reluctant to invest in the primary market on perpetual or long-dated cash bonds. Nevertheless, a minority of buy-and-hold private investors, looking for significant yield have taken any opportunity in new issues to invest in either subordinated debt or emerging markets bonds. Despite these few tickets, volumes have been globally on the downside.

Regarding interest rates structured notes, volumes have decreased quite sharply on new issues in 2006 compared to 2005 for various reasons. First, the low interest rate environment and flat curves both in US dollar and euro did not support large appetite from private investors. Moreover, most of the private banks interviewed had taken views in 2005, on scenarios such as a steepening of the curve, which proved not to be a successful view. As a consequence, some of these notes in portfolio currently have a mark-to-market below par and it is sometimes difficult persuade private banks to market similar interest rates structures again to private investors even if they actually show good value.

A few issues have nevertheless been reported, most of them very classical structures such as range accrual notes for which some clients always express some interest.

Contrary to the primary market, volumes on the secondary market for interest rate structures have increased quite substantially due to some reallocation strategy by private banks among different underlyings.

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ALWAYS SOME APPETITE FOR ALTERNATIVE FUNDS

Last year has been another year of investments from private investors, mainly from high-net-worth individuals, in alternative funds. Be it real-estate funds, hedge funds or private equity funds, the net cash inflows have been significant throughout 2006.

Apart from private investors' appetite for such instruments, most private banks strongly marketed these products, often with a global target of more than 10 per cent of a client's total assets in alternative investments.

SEVERAL NEW TRENDS IN 2006 AND 2007

A few emerging trends in 2006 give an idea of the products that could elicit some important new appetite in 2007.

First of all, tickets have been executed with private banks on either classical credit-linked note, synthetic collaterised debt obligation (CDO) or more recently on cash CDO equity tranches. This new trend, though still limited, shows both private investors' growing maturity on this asset class and the risk profile of some clients which is becoming more aggressive.

In terms of equity derivative structured products, private banks have recently shown strong appetite for achieving absolute and non-directional returns through structured products, either by investing in new uncorrelated underlying known as 'hidden assets' (such as volatility and dispersion) or by using structured products to extract manager outperformance, also called 'alpha', from mutual funds.

Finally, BNP Paribas strongly believes, based on the feedback from our main private banking clients, that cross-asset products such as hybrid products should be one of the leading structured notes products in 2007. Be it forex and interest rates, inflation and interest rates or equity and interest rates, all these combinations are without doubt underlyings that create a lot of value for private banking clients looking for a product delivering both a coupon and an upside on a specific index or basket.