INTRODUCTION

MAKING YOUR MONEY WORK HARDER

Bank and asset allocation companies have undergone sweeping changes in the way they work, reponding in a tailored and sophisticated manner to client demands. Elisa Trovato reports

The importance of asset allocation can never be overstated. The milestone study conducted by Gary Brinson in the mid-1980s, showing that over 90 per cent of the variability of a portfolio's performance is determined by the asset allocation of its assets, still holds true today, say asset allocators.

But in recent times, banks and asset management companies have made important changes to their asset allocation process, both in terms of the methodology employed to determine the allocation and the type of products included within it.

Klaus Martini, global chief investment officer at Deutsche's private wealth management division, tells of the major modifications that his bank's asset allocation strategy has undergone, since he moved from Deutsche's asset management arm, DWS, to the private bank four years ago.

In the past they would look at a single country economy, such as US or Japan, and consider to overweight or underweight assets in clients portfolios depending on how attractive these economies were considered to be. "Today, we are much more driven by investment themes," says Mr Martini. "Once we have identified an investment theme, we try to bring in products to give clients a solution for that topic."

One current theme is Asia, the effect of its population and consumption growth on the world economy and its impact on the demand for products or commodities. The type of product employed is not a priority, as long as the investment theme is covered. "It is very different from the past, when the product came first and the investment theme would come at a second stage to justify it," he says.

The house view, defining themes and investment outlooks, originates from the global investment committee, which meets four times a year and is headed by Mr Martini himself. It is then implemented at regional level by four investment committees, representing Germany and euroland, Asia, the United States and international markets.

The implementation of the investment strategy and its rapid translation into appropriate products is key, he says. "We speed up the process by bringing product people, both from DWS or third-party providers, to the table where we think about the investment themes and decide asset allocation. You wait too long and the theme will have probably gone."

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Andrew Popper, chief investment officer at SG Hambros in the UK, part of the private banking division of the Société Générale, recognises that during the past three or four years the asset allocation exercise has become a far more disciplined process in the French group too.

"The days of individual CRMs [customer relationship managers] or brokers are gone. The asset allocation system has become much more rigorous and disciplined and much more similar to an institutional approach of asset management," he says. Investment guidelines generated by the group investment committee, which is headed by the global strategist and meets on a six-week cycle, are

given to all private banks of the group. "The way that grading system, which is just an expression of sentiment, is then translated in specific percentages is at the discretion of the local entity."

A LONGER PROCESS

A different matter is that of realigning clients' portfolios to the general house view. If in discretionary portfolios, where clients give full mandates to the bank, this can be done immediately, claims Mr Martini, the advisory side can take much longer and sometimes will not be implemented to a full extent. There is still a lot of training work to do with the advisers and clients, in particular the retail and the affluent, confides Mr Martini. "We aim to convince advisers and clients to take more consistently the recommendations of the global committee," he says, explaining that the process of bringing advisory portfolios in line with discretionary portfolio management was started a year ago at Deutsche and it is not finished yet.

But even when the private bank engages in a discretionary relationship with the clients, there is often the chance that clients may want to change their strategic asset allocation as soon as the market becomes more volatile. Manuela D'Onofrio, director of investments at Italy's Unicredit private banking which is part of the Pioneer group, says that "the fundamental problem is that of finding a compromise between the clients expected return and their risk tolerance."

In fact, most investment houses, and certainly all the large ones such as Unicredit, SG Hambros, Deutsche or Handelsbanken, have moved away from the simplistic equity ratio-based way for assessing risk in portfolios. By employing sophisticated software tools, they define the optimal asset allocation for their clients, tailoring it to their specific needs and preferences, this way maximising the expected return given the clients risk profile and their investment time horizon.

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"Unfortunately the client always focuses on his expected return and does not take in consideration the other side of the coin, which is represented by volatility, the probability to have negative returns in certain periods of time. The risk is that the client may want to change his strategic asset allocation right at the worse time, suddenly transforming his strategic long-term portfolio into a short-term one," says Ms D'Onofrio.

This emotive behaviour, typical of the investment activity, affects even the high-net-worth investors, "who rarely need liquidity and should have very long investment horizons."

In order to verify the client's risk tolerance, many private banks often show clients the loss that particular asset allocation might have had in periods of financial stress, looking at the maximum draw down, calculating the largest drop from a peak to a bottom in a certain time period.

"Because when the market goes up, nobody wants to change their strategic portfolio, on the contrary they want to risk more," says Ms D'Onofrio. "When the market goes down, their ability to bear losses suddenly runs out, although those losses materialise only when investors actually sell."

DIFFERENT THEMES

Unicredit Private Banking oversees €55bn, of which €13bn is in 'Gestioni patrimoniali', discretionary portfolio services that can include individual securities, funds or both. Ms D'onofrio explains that it is their asset management arm, Pioneer Investment Management, which defines the bank's strategic asset allocation. The private bank's investment direction committee is then responsible for giving tactical indications of asset allocation. It also gives clients input in the selection of individual securities, while Pioneer is the third-party fund selector in the Multi-manager GPFs (Gestioni Patrimoniali Fondi), as the private bank does not operate in an open architecture environment, explains Ms D'Onofrio.

"When we review our [tactical] asset allocation and when clients review it are two total different themes," says Ms D'Onofrio. "The bank's investment committee meets once a month and theoretically we could make changes every time. Clients, unfortunately ask us to change asset allocation when they see a change in the market direction."

Of course, this depends on the clients, points out Mr Ulf Riese, head of asset management at Handelsbanken. "Some clients are happy to go through their portfolios once a year, and want us to have a very conservative asset allocation," he says. "Although we do recommend them to contact us as soon as their situation changes, such as in case of a divorce, or in view of buying a house, which is something that can alter the way the portfolio should be constructed.

"Some other clients want to participate very much in the daily business," he says.

Private banks and investment houses now approach asset allocation from the perspective that private clients' main objective is to preserve their wealth.

"Chasing an index does not mean anything to a private client, it is much more important to assure the preservation

of clients' wealth or its growth at moderate rate in the long term," says Mr Martini. At Deutsche Bank they don't promise rates of 10-15 per cent, but see 5 per cent currently as a realistic target, depending on tax and inflation factors. "We obviously try to achieve more [than 5 per cent] by employing superior products and make tactical asset allocation changes," he says.

This need to preserve wealth has translated in a huge demand for absolute return type portfolios in European private banks. Mr Popper says that this demand has lead SG Hambros to create an absolute return asset allocation model portfolio, in addition to the other six the private bank has got already.

Emanuele Vizzini, responsible of the discretionary mandates at Investitori, the Italian boutique investment house part of the Ras-Allianz group, says Italian high-net-worth investors are particularly sensitive to the theme of wealth preservation. "The idea of defensive investment is the historical legacy of the high returns of the 1980s and of previous years, which has remained in the logic of the investors at all levels," says Mr Vizzini. "BOTs – Italian government bonds – represent the typical "benchmark" that the private investor has in terms of defensiveness/return of their investment."

However, with BOTs currently returning just over 3 per cent gross and the possibility that their net return will be further eroded by potential tax increases, currently under discussion by the Italian government, comes the challenge to "redirect clients habit", says Mr Vizzini. "We have included flexible funds to complement the fixed income side of clients portfolios, because the risk free return offered by BOTs is very low," he says.

DEMAND FOR TOTAL RETURN

The trend of including alternative investments, hedge funds in particular, in clients' asset allocation falls within this logic of meeting clients demand for total return. This tendency seems to span all investment houses and banks throughout Europe.

Mr Popper at SG Hambros states that in the past two-three years "the most significant change has been the employment of hedge funds, which currently represent 15 to 20 per cent in the diversified model portfolios."

Mark Evans, head of Royal Bank of Canada (RBC) private banking in the UK, explains that in their asset allocation models the typical exposure to hedge funds is currently 15 per cent.

Mr Vizzini also says that "the real novelty for Investitori has been to take into consideration funds of hedge funds," recommending to thier clients, who are typically individuals holding €1m+ of investable wealth, that funds of hedge funds not exceed 25, 30 per cent of their portfolio. This is subject to regulation, though, as the minimum amount that Italian investors need to invest in hedge funds is €500,000. Moreover, it is down to clients to ask for these products, the advisers being prohibited to make any proposal.

Mads Kaiser, manager of team strategy in Jyske asset

Kaiser: hedge funds will soon be included

management in Copenhagen, also reveals that hedge funds will soon be included in the company's model strategies, which currently comprise only fixed income, equities and cash.

Mr Martini at Deutsche Bank says that in a balanced portfolio comprising 35 per cent equities and 30 to 35 per cent bonds, the typical asset allocation to alternative investments is approximately 30 per cent. Of these, two thirds are represented by hedge funds and the rest is in private equity, forex and commodities.

Over the last few years alternative investments gained in importance in asset allocation models and banks are advising clients to increase their allocation to hedge funds, points out Martin Keller, global head of hedge funds at the German bank.

"Most banks recommend a higher allocation to the most aggressive investors, which is wrong. Diversified hedge fund investments in a portfolio context are far less volatile, far less risky than equities for example. For a conservative client a higher allocation to hedge funds is more sensible than vice versa."

Mr Keller says that things are slowly changing in banks though. Clearly, expertise in selecting the hedge fund strategy and picking the right manager becomes paramount. "This is where Deutsche bank's expertise comes in," says Mr Keller.

Deutsche relies on very strong consultative relationship with DWS, in hedge funds as in the other asset classes, he says. "DWS runs a very large funds of hedge fund business and we are distributing a lot of their products and funds to our clients," says Mr Keller. "This happens despite us having an open architecture approach. In-house products undergo exactly the same selection and due diligence process as a third-party product."