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Asia's Wealth Managers Survey

the Quest for Income and Capital Preservation

Hubbis assembled a group of experienced independent asset managers to cast their eyes over the universe of balanced investing for HNWIs. The private discussion was co-hosted by Prodigy Network, an integrated real estate company based in New York whose business model involves sourcing and funding US real estate redevelopment projects.

Executive summary

Income and capital preservation are essential to high-net-worth investors the world over, as they turn more cautious after a year in which 95% of assets depreciated. Capital appreciation is still in focus, but today considered more of a luxury. Hubbis assembled a group of experienced independent asset managers to cast their eyes over the universe of balanced investing for HNWIs. The private discussion was co-hosted by Prodigy Network, an integrated real estate company based in New York whose business model involves sourcing and funding US real estate redevelopment projects.

The discussion began with Leonard Chinchay, VP of Client Relations, introducing Prodigy and explaining that the company has eight projects underway totalling around USD1 billion of investment. The finding model is simple, with about 50% equity, of which between 80% and 90% comes from HNW investors and smaller institutions such as family offices across 42 countries and 27 states in the US. So far, the company has raised about USD690 million from roughly 6500 investors.

The portfolio consists of different properties in New York and Chicago and the projects involve acquiring projects, redeveloping them, operating them for a period and then on-selling them to larger institutional investors.

The wide-ranging discussion saw the guests deliberate the search for income from a broad array of investments, from out of favour financial stocks and their debt to private equity, private debt and a host of other ideas. The overriding impression was that HNW clients in Asia have become increasingly cautious since the markets turned in February 2018. Even though markets have generally performed well since January, investors remain more focused on capital preservation and income than the additional luxury of capital appreciation.

Prodigy's Chinchay concluded the discussion by observing first that real estate ought to be in any HNW portfolio and that Asia's HNW community should consider Prodigy's formula of easy to understand, single-asset investments structured with the minimum of complexity but with considerable tax efficiency.

"WE KEEP IT SIMPLE," he explained. "Our preferred structure is to fund with 50% of the financing coming from major US banks and the other 50% as equity. Of the equity portion, we ourselves as general partners bring about 10% to 20% and we source the other 80% to 90% through our network of retail and institutional investors. We have been very successful in raising more than USD650 million from about 6500 investors so far in 42 different countries and 27 different states in the US."

The portfolio consists of different properties in New York and Chicago. "We are involved in co-living, co-working offices, hotels and extended stay properties," Chinchay explained. "We have been in the Asia region for two weeks already, Hong Kong last week and Singapore this week. We are here to promote our products and meet different distributors or different strategic partners in the region."

An expert involved in financial technology, quantitative finance, derivatives and portfolio management took up the baton to explain that his firm specialises in income, in a systematic multi-asset class income strategy. "So," he explained, "first you need to find the premium, where are the risk premiums, where can you collect alpha. That means we go where people don't want to go and right now the Eurozone is the most disliked area in the world for investors, everyone is afraid of that."

Going against the flow

He went on to explain that investors can find very high returns on financial sector bonds in Europe and on high yield. "As to sector, again we go to the disliked financial sector, where yields on banks are high, even higher than elsewhere in the world, where nobody likes the banks. As to instruments, again we go where people don't go, so for example subordinated debt, plain vanilla bond subordinated bonds, and with this sort of combination you can really generate income, of the range of 6% to 8%, for example. Not the same as real estate returns, but in Europe, you can leverage at negative rates, it is fantastic, so you can really enhance your overall income. Finally, we compress costs across the investment process, meaning

Hubbis - Prodigy Network roundtable in Singapore

management fees, brokerage, but also the fiscal impact, so mitigate withholding or other tax legally through swaps, futures for instance, as avoiding those sorts of costs is absolutely key."

Keep invested

With wealth market clients generally not needing income, "we recommend being invested at this time. A balanced portfolio is about 40% to 45% in equity, about 35% in fixed income, about 12% to 15% in alternatives and the balance in cash. The goal of the portfolio for our typical client is not to generate income, it is to compound up, to remain invested. And as to leverage, we are in the wealth preservation market, our clients are wealthy and want to stay wealthy, but they don't come to us to become wealthy. For example, we have no structured products, because we know how the fees are wrapped up inside them. In my 30 years in this business, not a single client ever asked me for a structured product, I actually think it is a monster the industry has created, and very few people actually need that" said one expert.

Alternative ideas

Looking at the alternatives space, "We are right now somewhat underweight fixed income and a bit more overweight on alternatives," said one attendee. "Alternatives, of course, occupy a very wide space, but we are focusing more on arbitrage strategies, not so much on long-short strategies. In addition to that, we are going back to fixed income, and with leverage costing about Libor plus 55 basis points, and focusing on shorter duration and emerging market bonds, about 75% high grade and up to 25% high yield. This produces roughly a yield of about 5.5% and we then leverage that at manageable risk levels."

And on equities, he reported that his firm is targeting about 50% core and strategic and 50% tactical. "We tend to take much bigger bets to generate alpha for clients," he explained, "trying to capitalise on the mispricing in the markets."

Playing the volatility

Another noted that his firm had been playing the volatility, focusing on high-income stocks, one of which yields 28% currently. "We have been creating a structure with a particular bank which gets onshore access in order to be able to smooth the tax benefit," he reported. "A lot of this is driven by the client within the field we are playing, and I think volatility is the one thing clients cannot stomach any more. So, we are probably more cash than we ever had but play the volatility scheme in order to create the revenue stream in order to smooth out the volatility. Of course, if we have high volatility, our premium yield is close to 20% a year, so that cushions a lot. Accordingly, we are trying to do a lot of bottom-up and to see how we can optimise it."

LEONARD CHINCHAY
Prodigy Network

PE for the people

Another expert explained that his mission is to broaden out interest in the retail market for private equity. He reported that PE is an asset class that is not well understood by a lot of individual investors, but that his firm had created a private equity-backed asset-backed bond with a credit rating of single-A and a yield of between 5% and 6%.

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underlying assets are more than 38 diversified PE funds with some 600 companies underlying them and those funds generating cash flow. He explained that a typical private equity fund has a 10-year fund life and in the last five years of that lifecycle they are selling assets, so there is a lot of cash flow being generated. Also, there is also a credit line in place in case there is not enough cash flow to pay the coupons, allowing the structure to draw on the bank credit line to pay the coupon. Accordingly, he maintained, there is very little risk of default on the payment. The overall mission is to diversify the product range for retail investors.

Another expert agreed that private equity is also a core area of focus, with their current specialisation on infrastructure funds. "We originate a fund, we look for environmentally friendly green tech type projects within the Southeast Asian region and we bring in strategic investors. The fund life is about four to five years and we have an exit strategy whereby we would get investors to buy the projects at the end of five years, or essentially look into a business trust structure where we can recycle some of these assets or set up a fixed income product where we can put into the next fund. A relatively new business for us, but we are in the midst of sorting projects now in the region, meeting with various government bodies, and talking to various investors."

Seeking the gaps

Another guest highlighted his firm's two core strategies. We originate primary trade transactions and structure those and put them into a fund format for investors to invest into, this is quite conservative by nature and some of the largest public and corporate pensions out of places like Switzerland, Japan, and so forth are our core investors. We tend to play where others don't want to play, so the banks have tended to lend to the top 15 or top 20 corporates in each jurisdiction, but that has created a huge capital gap in the region and people are looking for alternative financing away from the banks. Accordingly, we run six strategies yielding anywhere between 5% to 12%, all senior secured. We have 27 cumulative years of track record across all of our funds, with never a single down month. The way we achieve that is we actually have the senior tranche of the particular structure and we ensure that there is a degree of downside protection, that is by way of the collateral of the asset, cross guarantees across corporates, principal guarantees where possible and insurance cover where necessary."

The second core part of this guest's business is asset allocation. "We have a conservative fund across all asset classes, heavily towards fixed income, alternatives and cash at the moment. We were fortunate that in July/August last year we opted to move out of equities and into fixed income. That has proven to be a good tactical move over the last six months."

Illiquid assets? Yes, please

Another attendee picked up on the theme of illiquidity premium still to be exploited. "Clients all run around saying they want to UCITs or something with daily liquidity,"

he reported, "and often we can give them something with monthly liquidity or quarter liquidity but with a noticeable pickup in yield. The asset class is not for everyone, it is the private debt market, but those who don't invest often decline out of ignorance. Sometimes I am asked how we produce a 12% return and I ask them what the banks charge for credit card debt, so the answer is that in places like the Middle East is it 50%, in Asia 26% to 30% and the default rates nowhere near what you might expect. Private debt is definitely an asset class."

He also remarked that he worries about the fixed income space. "I suppose the only way I can sleep at night on the fixed income portfolios is that we have such a crazy leadership at the Fed and I think if there is a sell-off in those kinds of stretched markets, they will be buying up the paper just to bail the economy out, but otherwise it is mispriced in my view and leaving the Fed aside I could easily see this stuff sell off 30%. Turning to the UK market, clients there are older and want income, so anything of 3% or 4% that preserves capital is appealing to them. Actually, with a conservative risk profile, at the moment it is quite difficult to hit even 4% after costs."

That, he explains, is what his firm is also focusing on assets suffering from illiquidity. "For example," he reported, "ground rent funds paying the 4% to 5% area, microfinance with long-term track records paying around 4% to 4.5%, this is all quite diverse stuff, we are searching around for little pockets, that is why I am taking notes here today!"

A new world of compliance

A family office expert introduced himself, noting that his firm provides outsourced family office services, with a major focus on how families structure their wealth and how they establish their succession arrangements, as well as managing regulatory concerns. "Clients are now actually having to think about tax and paying the tax," he remarked, "so in the fixed income space suddenly a gross yield becomes a net yield. And as you actually have to disclose the gross yield you received, the leveraged portfolios for a lot of these investors are no longer suitable because they don't have the spread any longer, because it is going to the taxman."

He observed that in this environment clients, particularly the high net worth individuals, must look at their wealth holistically and structure and report their wealth efficiently and openly. "They are exposed to very substantial liabilities on that side," he added, "so, from an income perspective, we must make sure that

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the structure that is utilised is tax efficient for the end user. Creating feeder vehicles which can cater to investors in multiple countries and jurisdictions to come in through the right feeder vehicles into the right underlying master funds is exceptionally important today."

Conservatism and diversification

An attendee said he would broaden the discussion out beyond specific investment opportunities.

Trading in trade

Trade finance is an interesting area. "We have been in this since about 2014 here," it was reported, "and with a local partner, we focus on small to medium-sized companies that need financing. We have been quite active, no bad months so far and year after year of positive returns of between 6% to 8%. This might be boring, but people like it and the preservation of capital is very important. We have also been expanding this strategy to other parts of the world, be it in Europe or be it in Latin America. There is no correlation to the equity market, no correlation to political risks, it is all US dollar denominated."

"We are a pure advisory model so we are very bespoke in the way we advise clients, everything comes from what the clients want to do and all our clients are different. However, all our clients are more looking for preservation of funds rather than growth, if they wanted growth they would mostly invest in their own businesses or real estate, so their goals with us are to achieve 5% or 6% and beat inflation. Additionally, they prefer generally to diversify away from the home markets, hence we try to find some ideas which provide uncorrelated returns as well."

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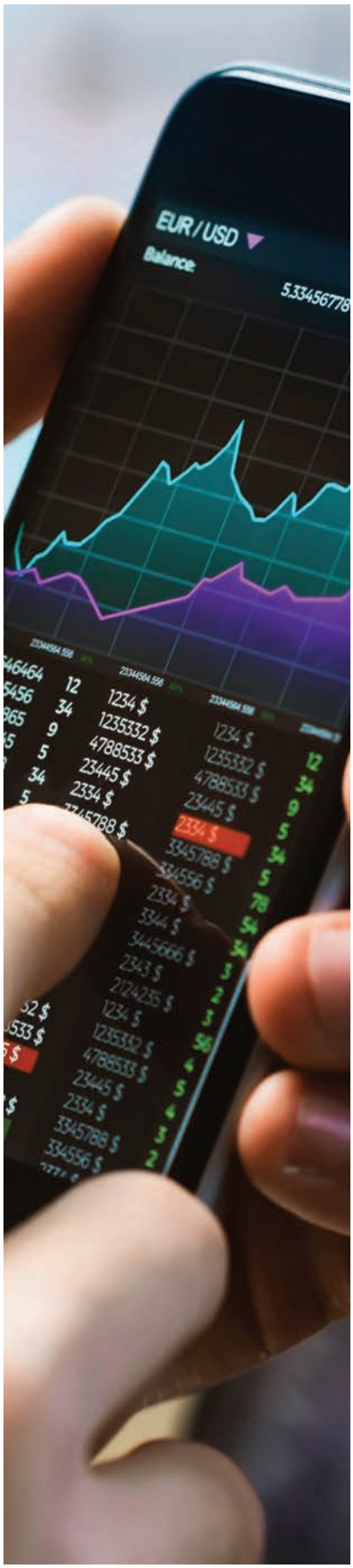
Beware fixed income

The discussion turned back to the fixed income markets, with an expert opining that rate hikes appear unlikely. "The global economy is looking pretty grim quite frankly, "and as to Europe, my view is pretty negative. Consequently, you are going to have to move up and down the credit curve to get really what you want or look at some-



thing slightly more esoteric. We are putting structured bond portfolios into Middle Eastern accounts, plain vanilla stuff, BBB, single-A, books of different credits, diversified, four times leveraged, using bank balance sheets, and they are very happy with what are quite decent returns on this. Generally, picking credits out there right now is tough."

He added that the liquidity profile of bonds is terrible currently. "It is back to where it was in the mid-80s to early-90s. I think MiFID ii has destroyed liquidity in Europe, there is no doubt about it. My view overall is to go back to basics, find something that is simple, stable, I am not going to walk them down the credit curve into something that is going to blow up, it is not going to help me, it is not going to help them."

Another expert highlighted some fixed-income sector risks that the Bank for International Settlements (BIS) had reported, such as potential mispricing in BBB and lower rated bonds. "If you feel that there could be recession risk," he noted, "some fixed income markets might still be mispriced, so if there is a recession, we could see more meaningful repricing, leaving aside what the central banks might do. And in the private equity space, we have participated in some of these late-stage pre-IPOs, like Spotify and Palantir and so forth, but even in those names that are well known, people actually marking them down to reduce exposure."

Experts? Hmmm

A bigger picture view came from a guest who commented that there are too many supposed market 'veterans' or experts who have only 10-12 years of experience but in fact only in a world on financial life support.

"None of them has seen an interest rate cycle, none know what a floating rate note is, or have never seen real yield curves, it is an absolute fiasco. There was the CIO of a global investment bank on the screen today, he has been there for eight years and in the business for 12 years and he is global CIO of a global bank. Do we, therefore, have a comparative advantage because we do know what's coming down the road and we can prepare people for that?"

Targeting real estate

The discussion closed with Chinchay stepping back from the discussion to observe that the common denominator from all the diverse comments and insights he had heard during the event was a focus on the clients' asset allocation and asset preservation. "I think clients after 2008 have wanted to have a little more control on the type of investments they take on," he observed. "We offer a very single asset fund structure, where the clients pick and choose the type of real estate investment that they want to invest in. We offer prime commercial real estate properties in prime locations, for example, currently six key locations in New York. We bring the clients the combination of income and capital appreciation based on the cycle of the investments include acquisition, development, operation, and then the sale of the asset."

Of the six New York developments, two of the properties have completed the full cycle, including the acquisition of the building, redevelopment of the property, operation for a certain time and the sale of the asset to the institutional investor market. "We have around 6500 investors in 42 countries, retail and institutional such as multi-family or single-family offices in various countries of the world, all seeking exposure into the US, into specific single-assets."

He then addressed some more technical aspects of the structures, explaining that Prodigy created a feeder fund that provides an established portfolio loan structure that reduces the tax rate to the investor. "We can offer roughly the first 10% to 12% of their return completely tax-free and over that the tax rate is around 15%. The investors do not need to report into the US, as they come into a US corporation that is a tax entity in the eyes of the IRS."

"What I heard today is that asset allocation is essential, a balance between bonds, equity, structured deals, private equity, and so forth. And we are firm believers that real estate should be part of the portfolio of each investor." ■