Mindsets and strategies: Helping HNW clients adapt to volatility and doubt

Hubbis and co-host Commerzbank gathered Asia-based investment product leaders from private banks, family offices and wealth managers for a private discussion focusing on how to help clients adapt their mindsets, investment strategies and portfolios as the market seemingly transitions to a more volatile end-of-cycle phase.

Executive summary

If a private banker, family office or other wealth adviser is hoping to build their client base and assets under management (AUM) in the years ahead, should they now be carefully positioning their high net worth (HNW) clients towards a less bullish approach to the mainstream financial markets?

A group of experts assembled in Singapore by Hubbis and co-host Commerzbank appeared to say 'yes', while at the same time arguing that an 'ends of days' scenario remains a distant prospect.

The flow business for the wealth advisory community has slowed markedly this year. Even though most of the guests at the discussion said that the first quarter of 2018 was positive, events in April, coming after the spike in volatility that appeared earlier this year, had encouraged more of them to analyse their clients' portfolios in greater depth and to advise more cautionary investment strategies.

Some of this shift is more readily possible for those private banks, for example, that have managed to build their discretionary portfolio management (DPM) business in recent years. One attendee noted that his bank has managed to shift 30% of its AUM to DPM in the past three years, from just 3%.

But that is not the case throughout the wealth advisory market in Asia, with many firms still behind the curve in this regard and still heavily reliant on product sales.

Even those institutions with a reasonable portion of their AUM migrated to DPM must rely considerably on product sales, as pure advisory fee revenues remain elusive in Asian wealth advisory.

Accordingly, for both the DPM business and for the formation and adaptation of their clients' self-managed portfolios wealth advisers are engaging with more conversations with Asia's HNW and ultra HNW individuals about what type of products, ideas, sectors, themes and investment philosophies they should be pursuing in this late-cycle of the mainstream financial markets.

On this, there was considerable divergence amongst the experts at the discussion.

Some believe structured products are go-to instruments; others believe they are to be avoided. Some think frontier equity markets such as Vietnam have more upside, while others argue that Europe offers greater opportunity. Private equity, private debt and other alternative investments have stronger legs than the public market instrument, according to one attendee.

A banker said that dollar rates will not rise much further and that this is a unique opportunity to build a very long-dated fixed income portfolio. And one expert highlighted the appeal to HNW clients of Environmental, Social and Governance (ESG) investment principles.

The overriding message that came out of the discussion was the flow business is unlikely to recover the momentum it has enjoyed in recent years. Accordingly, wealth advisers and their clients need to put their thinking caps on, and fast.

THE DISCUSSION, WHICH TOOK PLACE IN SINGAPORE on an off-the-record basis, provided a forum for wealth management peers to debate their approaches to the current state of the global economies and financial markets.

The underlying premise for the conversation was that the seemingly unshakeable faith global investors have shown for the mainstream global financial markets over the past decade might be weakening. Should wealth advisers, therefore, be helping re-position their HNW and ultra-HNW client portfolios?

Market tremors felt in early 2018

While the first quarter was, for almost everyone, an excellent period as indices rapidly recovered from the sell-off that began in late January, wealth experts attending the discussion reported that April was far less so.

"Consequently," said one attendee, "we are adapting our stance to advise clients towards some credit plays, credit linked notes with overlay to swaps, and we will also look at physical delivery, which could be the next big thing in the months ahead, this is rather like replicating equity payoffs."

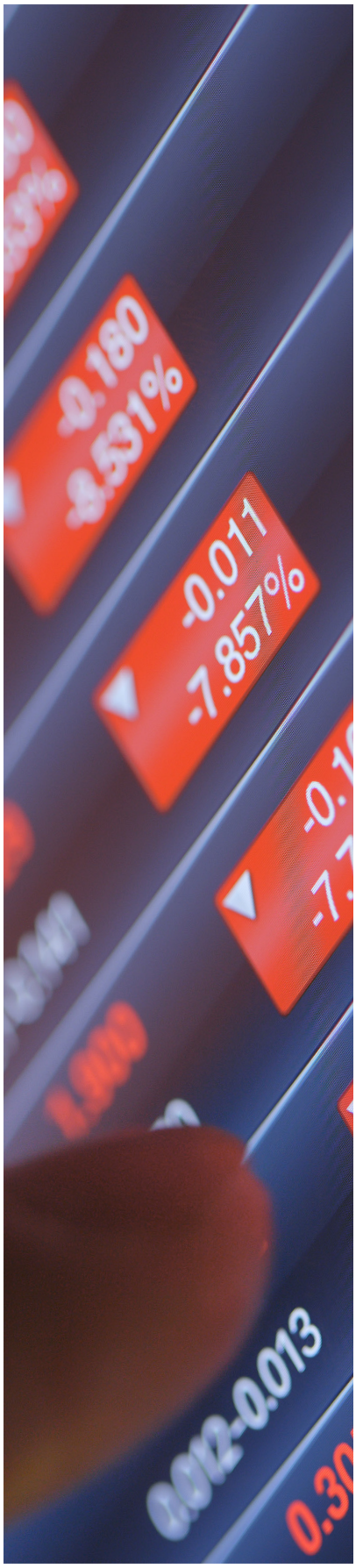
Another guest noted that with interest rates inching higher, some opportunities have re-emerged in the longer-dated space, in particular, rates-linked but also in the equity-linked market as well.

"But," he said. "If we do go into a real correction in the mainstream markets I do not think those will make up for what we as a wealth management business are going to miss on the flow side, which has been so strong for so many years as indices moved almost ever upwards."

"Accordingly, for me, top of my mind is that we probably need to sell more fixed income and we need people to do more FX because that is less directional. From our perspective, it is essentially about diversifying our sources of revenue," he added.

While that perspective appeared to be driven as much by the need to bolster revenues for the private bank, a more wholly investor-focused approach was added as one guest noted that so many investment strategies had been correlated in recent years.

"One of the opportunities opening up as markets wobble somewhat is to look for and use other types of data that people have not



used; when people use the same data, they end up getting the same returns, so one approach is to find and use different data."

The near-standardised data has to some extent resulted in the products wealth advisers sell to their clients having become standardised in recent years. "We are certainly having more conversations about diversification of products, markets, regions," reported one expert.

Momentum trades slow

Another private banker noted that the momentum business that was so strong in 2017 has all but disappeared.

"We have therefore gone back to doing what we have done naturally in the past, namely looking at esoteric payoffs, talking about dispersion, outperformance and so forth, aiming to differentiate ourselves and our approach, as we have managed to in the past," he said. "We also spend a lot more time now analysing client portfolios, and helping convert clients to better risk management conversations, reminding them about transactions that are possible to cover the downside, while retaining upside performance."

He added that there are some benefits of rising interest rates, especially in dollars, is that it helps focus minds on the theme of hedging. "The bank is looking at converting fixed-rate assets into floating-rate assets, hedging out loans, not only the exotic swap-based payoffs, the callable products but also talking about portfolio hedging in a systematic manner."

Another banker noted that his bank is also pursuing hedging strategies, with plenty of conversations resulting in strong demand for lower correlation positioning across the assets in the wealth portfolios. "We have been looking towards alternative assets, hedge funds, and PE [private equity] funds, one of which we recently sold to very strong demand here in Asia with a European focus."

Alternative assets might gain lustre

He posited that demand for the fund was so robust because, in traditional asset classes such as equities, the world is ten years into the bull market and therefore on balance, private equity is more likely to outperform the public markets over the next five years.

"And in the fixed income arena," he added, "we have rising rates, cash or gold have no yield, inflation is coming up, so again this is also helping drive our preference for and push towards alternative assets."

He also pondered whether the markets had changed sufficiently yet for client psychology to have yet altered significantly.

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chology," he said, adding that as they gradually move towards a portfolio with reduced correlation, one needs to understand if those clients are making a tactical shift as a reaction to the volatility in the market recently.

"Or if they are making a strategic shift in their portfolios which is the recognition that we are moving later into the economic cycle away from 'goldilocks' markets and towards rates at more neutral levels when there could be higher volatility," he said. "The clients need to work through these issues to properly analyse and understand their motivations."

The comfort of yield

Another banker highlighted the appeal of dividends amidst market and index volatility, pointing to a REIT ETF his firm had launched in October.

"The return for the Singapore REIT market has been about 10% compound annually in recent years, with roughly 6% from dividend yields and 4% from capital gains," he said. "We continue to see inflows despite the stock market volatility, as Singaporean and other HNW investors, including sovereign wealth funds, regional pension funds, remain very focused on yield."

According to him, the trend is very clear in that investors want low cost, transparent products such as REIT ETFs.

"We also see inflows from robo-advisors, from millennial investors and I think this fits the future trend, namely a greater focus on transparency, low cost, solid sources of income, whether rates are rising or not," he said. "And for this type of product, if rates rise that means the economy is doing well and therefore the REITs should continue to perform well."

Volatility, yes, but it is far from panic stations

One attendee asked guests what other conversations they were having with clients about trying to generate income at a reduced risk level compared with recent years. One expert from a global bank opined: "We are not suggesting taking money out of the markets yet because we do not think that the music has stopped. Yes, there is volatility but no need to panic."

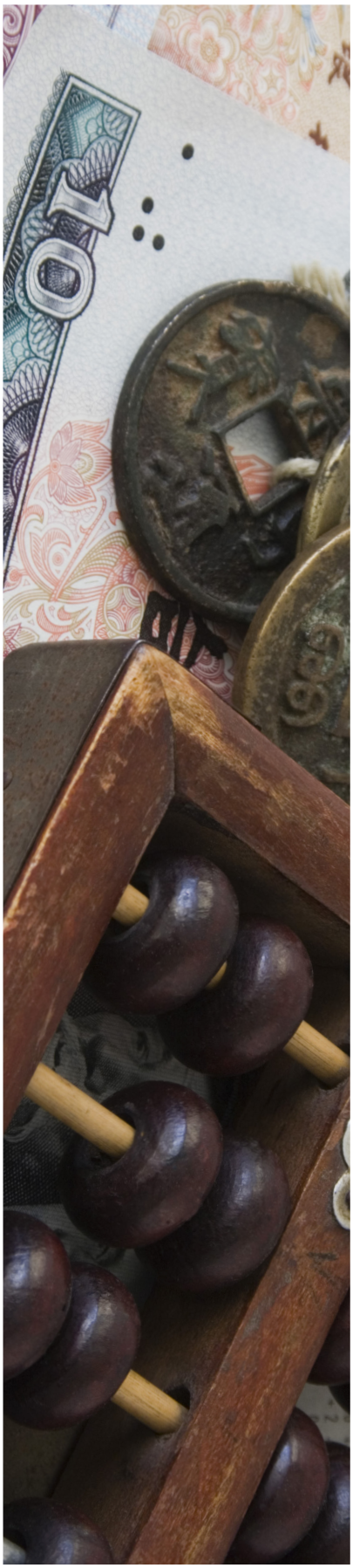
He agreed with the prevailing view that Q1 this year was as positive as 2017, but that performance and sentiment changed in April.

"We do feel clients need to become more active," he said, "and that requires leadership and guidance from us." He added that his bank likes income and is asking clients to sell optionality so that they generate some fixed coupons.

"But the big picture," he noted, "is that we are generally a bit more cautious, so we are reducing duration risk and increasing the equity payoffs to having the physical delivery. We want the investment wheels to keep spinning, for sure, but it can no longer be done on autopilot and requires more active management and more care."

Another guest pointed to the uplift in volatility this year driving demand for structured products. "In general terms," he explained, "higher volatility results in better strikes, better coupons, and coupled with higher interest rates essentially allows for a higher carry." He added that one of the critical conversations the bank has been having with wealth clients is to look at the entire portfolio, to check if the portfolios are too narrow, highly concentrated.

"If we see inventory which can be turned around following a risk management conversation, that is very exciting."



Leverage – yes or no?

Low-interest rates for many years have allowed for hefty leverage of wealth portfolios. "On the discretionary side," reported one banker, "one of my biggest concerns right now is that if interest rates hike far too fast, this will likely force clients to deleverage, but for the moment, it is manageable."

According to him, there is still time to shift fixed income strategies and add some equities to portfolios. "As we are very positive on the economy, and we see 10% further on the upside in the markets," he said. "Our best-case scenario expectation is that rates will not rise too far and too fast, the economy will continue to thrive, and therefore overall we are fairly relaxed at this time."

One guest referred to the global financial crisis (GFC) when financial markets crashed, resulting in a bloodbath for structured products. "But the difference is that today we have a short-term rate of less than 3% in dollars, whereas during the GFC it was about 6%," he said. "A decade ago we might have seen ten times leverage in an emerging market bond portfolio, but today the level of LTVs in most banks has become more reasonable, and the control and governance on leverage have also improved."

Another banker added that leverage is no longer as cheap as it was a decade ago, the spreads above Libor are higher.

"The banks today are better protected, and so are the clients," he argued. According to him, the entire process of how you get a product on the shelf and how you explain to the client and what are you responsible for, cannot be compared to 2008, as regulation and internal processes have significantly evolved.

"We used to sell credit-linked notes to almost anyone, but now it is a much more detailed procedure and often ends with the client preferring not to buy as they become so aware of the risks," he said. "Therefore, we believe the leveraged portions of the portfolios are less susceptible to a specific part of the market blowing out."

Migrating AUM to discretionary

The conversation turned to the efforts wealth advisers are making to increase advisory fees and discretionary portfolio management (DPM) as global regulation tightens and as the prospect for more challenging mainstream financial markets becomes more likely.

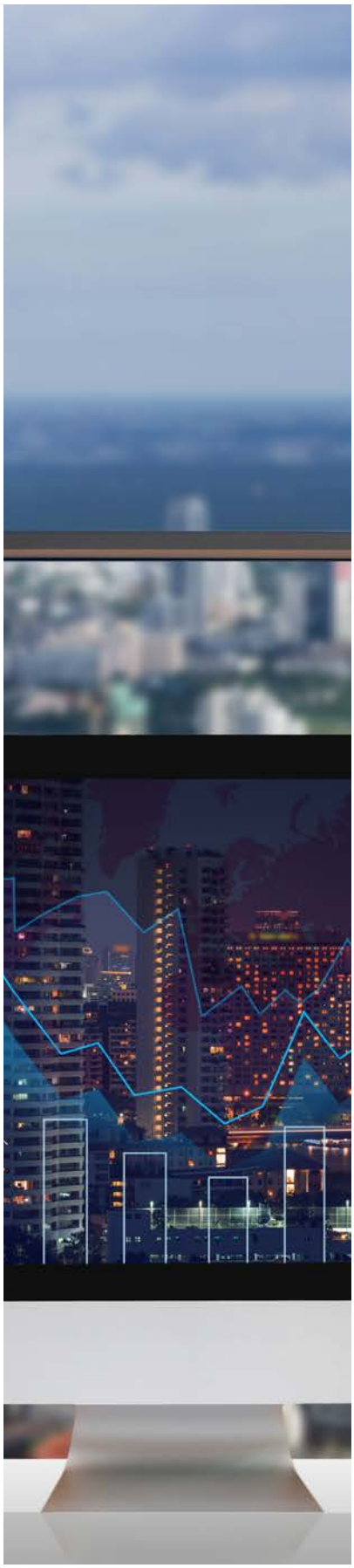
One banker highlighted his bank's DPM growth from 3% to 30% within the past three years, although he conceded that the next phase might be more difficult, namely to grow further and build scale.

This rising penetration of DPM by banks within their wealthy clientele is, however, not universal. "In truth," reported another private banker, "in this regard Asia remains far behind Europe." He added that his bank is in still very early stages of change and remains very transaction oriented.

"Our discretionary mandates numbers are considerably lower than some of the numbers I have heard today. While we do have the comfort of a very large funds business, we certainly want to boost our DPM penetration."

The representative of a local Asian bank noted that for the bank's DPM business there has always been a conundrum between trying to build scale and recognising that there is still a lot of scope for customised portfolios.

"A lot of the equity in our business lies in the relationship between the portfolio manager and the client," he said, adding



that they have found that clients who meet with our RMs to review DPM maybe twice a year and whose portfolios perform to par or above the market, tend to stay with the bank.

"That helps us plan to build scale and to do so we have to find the balance between a unitised approach to DPM and also making sure that the personal touch is still there," he said. "This is a challenge for us, and we are learning along the way."

A representative from a 'boutique' global private bank pointed to the freedom the bank's RMs have with clients. "We are not part of a global, universal bank, we operate open architecture, and our RMs are attracted to join us because we do not push product, we allow them to sell what they want," he said. "They have their budgets but how they achieve those is really up to them, but this approach does help build client trust and loyalty."

But, in general, the private banks are becoming more 'corporate' in their procedures, and the prevailing theory is that this helps those banks drive their clients towards more DPM mandates.

"There is always a trade-off at the banks between entrepreneurial behaviour by the management and RMs and what works for the clients and the bank itself," he added. "What has happened nowadays is that there are better systems in place within the banks to help make sure that ideas and products work for all parties."

Products for HNW and ultra-HNW clients

The discussion turned to other products and strategies for wealth that had not yet been covered. One expert said he would encourage clients towards a very long-dated fixed-income portfolio because he thinks the 10-year dollar rate will struggle to cross 3.5%. "We see this as a once in a lifetime buying opportunity," he stated.

While one expert cautioned against structured products, another said the whole structured products regime has improved considerably. "I think the governance around these products has risen to such a degree that we can still put in a pretty good trade, be comfortable and get a good pay off."

Another guest highlighted the appeals of South Korean equities. "There are numerous companies there that are very exciting, very competitive, and the overall market is very cheap. I do not have great concerns about the north-south political situation, so my suggestion does not factor that in."

Still focusing on equity and Asia, another guest highlighted the appeals of some emerging markets, in particular, Vietnam and Thailand.

"Vietnam might have surged almost 50% last year, but we still

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believe it has more legs, albeit with greater volatility."

Another attendee said their firm was talking to clients about CDS and taking credit duration risk as opposed to rates risk. "Take macro indices, stick in a very low strike and just pick up the floating rate carry or fixed rate carry of 5% to 6% because relative to that, the cost of financing is still cheap, you are taking a fairly easy view that markets do not end up correcting 30% from here, and you sit on the carry," he said. "It is far better than being long questionable high yield paper."

The same guest opined that the markets are probably going to get a lot more interesting with rates behaving the way they are and people rebalancing their portfolios.

"Maybe we get two or three strong bull rallies this year, followed by equally strong sell-offs, so the key would be to time that well and be able to monetise those opportunities," he said.

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A banker noted that the bank was currently underweight fixed income and marginally overweight on equities, primarily because of the European equity space. "Europe is still about one to two years behind the rest of the world in terms of their economic cycle, and I think that the political backdrop in Europe has also improved somewhat over the last few years, so overall, we think that sector remains positive."

The theme of socially acceptable investment, known as ESG (Environmental, Social and Governance) was also raised. "We have decided to embed it completely in our investment process," said one attendee.

"We absorb the cost now because we believe in it and it has become a full part of our investment process right now. We currently use ESG in all our discretionary and advisory mandates."

While there was some considerable divergence in opinion as to which products, or themes, advisers should promote to their clients, there was a clear consensus that the path forward for the mainstream financial markets is less well-lit than in recent times.

Caution, the guests felt, should take a higher profile, but fear is not yet a factor. ■