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The Art & Science of Curating the Best Private Client Investment Portfolios

Hubbis organised a private virtual discussion on August 4 in association with our exclusive partner for the event, DiligenceVault. The topic was the curation of investment portfolios for private clients in Asia, which in the past decade has required an increasingly sophisticated and dedicated approach from the wealth management providers, as regulation has expanded, as the need for quality and differentiation have increased, and ESG-driven investing has taken root. All these factors, and more, have made the selection of assets, funds and managers significantly more complex and challenging. A fascinating, informative (and entirely off-the-record) discussion took place, from which we have selected the following key observations for this report.

Exclusive Partner

THESE WERE SOME OF THE QUESTIONS ADDRESSED BY THE PANEL OF EXPERTS

- There is much discussion about ESG and sustainability. What does that mean in reality?
- Have the criteria changed around how you select funds?
- How do you balance creating bespoke portfolios for clients with scalability?
- How do you analyse and optimise client portfolios on an ongoing basis?
- What does digital mean in the context of portfolio optimisation and management?
- How do you ensure the funds selected and the assets chosen are well managed and compliant?
- How do you select the best-in-class fund managers in a remote working world?
- What tools have you used to monitor specific research criteria?
- How do you keep track of assets and funds on a real-time basis?
- Are you adding more products or reducing the number of funds on your platform?
- Are there changes to the way you conduct due diligence on funds today?
- Are the regulators and your own internal 'operations' encouraging you to look at your fund selection process in more detail today?

Welcome Address

Providing the delegates with an overview of the firm, its services and its key personnel, New York-based CEO and founder Monel Amin first offered a brief introduction to the firm.

Monel Amin: "I am the founder and CEO of DiligenceVault, which we launched about seven years ago after working in capital markets and risk management in New York. DiligenceVault is a technology platform that has created an ecosystem that sits between asset managers and fund selectors to help with the streamlining and automating of key due diligence activities, both pre-investment and in terms of ongoing monitoring. We help streamline the process of capturing data from fund managers via RFPs and due diligence questionnaires. I am pleased to say we have over 21,000 users across more than 90 countries on the platform. Our clients consist of allocators including institutional investors, private banks and HNW platforms, as well as asset managers across long-only, hedge and private equity strategies."

"We have seen an increasing area of focus on ESG, where more and more clients are directing their AUM. However, the lack of standardisation on ESG metrics and concepts a key hurdle. This does, though, create a new opportunity for firms that are able to provide transparency to their clients and they can use DiligenceVault for simplifying and streamlining all of their data collection.

"We have seen a tremendous amount of growth from that perspective, because in an environment where things are not standardised, where things are moving at a fast pace, it is challenging to create the best portfolios, and also to communicate clearly with your clients using a lot of that data. That is where we've seen a significant amount of focus on leveraging technology to enhance and even strengthen the existing due diligence processes."

She also commented that their clients are also increasingly focused not only on the investment diligence, the initial front screening, but also ongoing monitoring, compliance and operational due diligence, especially of regulated products. "One of the motivations for clients to go digital in those areas is if they want to start scaling and bringing new options without having to increase their cost base, and just having faster access to data."

"Our role assumes great importance for some of the smaller funds and managers who find the due diligence process they must go through with wealth firms or banks quite onerous because everyone's sending them different diligence requests, but in reality, asking for similar types of information. In that space, most shops and most fund selection teams have their own diligence processes, so providing efficiencies to some of these smaller or newer managers who may not have the resources is often very important and valuable to them. After all, not all funds have multi-billions in AUM. So that is where we are seeing some of the boutique and smaller managers become more active on a technology platform because it is more efficient, especially when they're responding to different fund selector teams who are asking for similar questions, and they can repurpose everything on a platform as opposed to managing it through what might be version twenty five of a Word document, for example."

(For more insights into the model and the DiligenceVault team, please see this link to our recent Hubbis article entitled 'Digital Platform DiligenceVault on the Need to Drive Fund Due Diligence into the Modern World')

At a Glance – The Key Observations and Insights

In global mainstream investment market conditions that still appear so accommodating, investors are almost obliged to keep risk assets elevated.

But investors and advisors should be wary - actions and events can surprise and alarm, as evidence by China's recent reining back of the technology giants.

As ESG-driven investing expands dramatically across the world, there are even more challenges for investors, advisors and asset allocators.

This is especially true because there remains a lack of standardisation around ESG ratings and metrics, meaning that advisors, gatekeepers and asset allocators must also devise their own highly transparent standards.

Many leading banks and wealth managers might fly the ESG and sustainability flags, but they find it difficult to prove their differentiation, partly because the front-facing advisors struggle to fully understand and then communicate the principles.

A proper understanding of the clients' risk appetites is vital for portfolio curation; advisors must encourage investors to focus on potential downside and volatility.

The modelling of risk scenarios can be very helpful in devising relevant and suitable asset allocation for portfolios.

DPM and advisory also require more careful and sophisticated curation of products and ideas than ever before, and the core-satellite approach is increasingly prevalent.

In an increasingly complex world and investment environment, more resources are being allocated to manager and fund selection, driving the need for smarter solutions to these challenges.

But while the major private banks have vast resources, this is far more challenging for the independent wealth management players, who urgently need more support and solutions.

Wherever possible, wealth management providers should try to leverage group and partner resources to help boost the portfolio curation process.

Private wealth advisors and investors must be especially careful of sticking to quality and seeing through the mists of disinformation as many companies and their managers might not be quite as 'good' as they seem at first glance.

In portfolio curation, the smaller funds and less prominent managers should not be ignored, so considerable effort must be made to assess them as well.

In the world of bespoke wealth management, advisors should always be prepared to advise clients objectively, and to caution them against unwise investment decisions – protecting your clients from emotional decisions is a vital element of your value.

In market conditions that appear so accommodating, there are few alternatives to keeping risk exposure relatively elevated

An expert observed that as markets remain so buoyant, it is a case of what he termed 'TINA' standing for there is no alternative. "You take on risk exposures because you are virtually forced to take and keep such risk because the markets have just been going one way," he said, adding that this environment dates back to the central bank interventions years ago and then since the pandemic hit, meaning few investments have performed poorly and most have done extremely well.

However, warning bells do ring sometimes, as evidenced by China's recent actions over the tech sector

Nevertheless, he cautioned that the actions of the Chinese government in curbing the technology sector served as a warning bell for investors. He said risk discussions are tough with any client these days, but unknowns do arise, and the Chinese government has illustrated just how this can come out of the blue. "The actions highlight how proper risk management occasionally does pay benefits, especially if you've overexposed yourself to any particular strategy."

Due diligence on funds and managers is increasingly complex in an increasingly complex environment

The same expert observed that due diligence is increasingly complex these days due to the array of metrics out in the market, including ESG ratings and the far greater regulatory demands across the globe in the past 10-12 years since the global financial crisis abated.

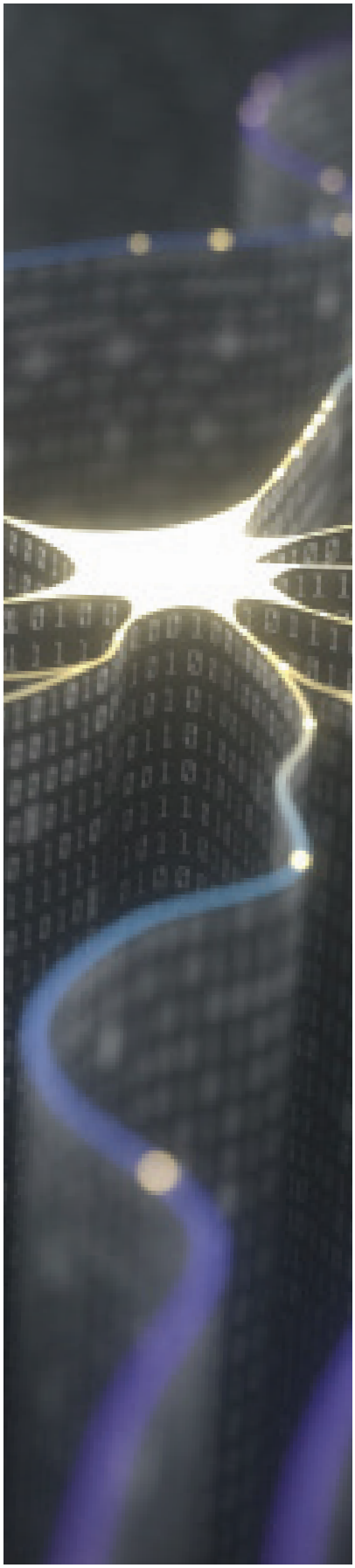
ESG-driven investing is growing exponentially, raising new challenges for the wealth industry

An expert observed that ESG could be seen as a risk management tool because ESG can help filter out those companies that are best governed, that are well diversified, and that have better-managed businesses. "There is more upside and less downside, so the screening that we conduct for all funds includes ESG ratings," he reported. "And we see a significant rise in interest in Asia for ESG, green investment products, even green structured products and notes; it really is exploding, especially as clients see better returns from these strategies, rather than needing to sacrifice some return.

The lack of standardisation in the ESG world is a major impediment to adoption, so gatekeepers should devise their own filters

A banker highlighted the lack of an agreed standard rating system for ESG, and remarked that their [major global] bank has its own sustainable investments classification framework and also conducts its own due diligence on their core conviction list of funds.

"Transparency is vital in the absence of standardisation," they explained. "As long as you're clear about how you define your products and what goes into your selected universe, investors have comfort that they know what they're getting into. At the



same time, we need to help drive towards standards alignment."

They also explained that the bank first applies a relatively straightforward and basic filter based on Morningstar Sustainable Investments, although the actual funds then selected by the bank represent only a very small cut of that preliminary list. "We reduce the list based on our in-depth due diligence and proprietary framework to come up with our high conviction list, and we definitely find that in this process, there are many funds that are not really walking the talk, so they are all filtered out of the equation."

Differentiation is difficult to achieve and more difficult to convey to private clients

Many of the private banks might say they are ESG and sustainability leaders, but it is tough to prove it and then convey that to clients. A banker observed that the real hurdle comes at the RM level, where they are often not that well equipped to have the sophisticated conversations with their clients. This banker commented that they had made a lot of progress with their own front-line bankers, recognising that this is really the key to differentiation, no matter what actual commitment the bank makes behind the scenes.

Risk assessment and scenario projections are essential for portfolio curation

A proper understanding of the clients' risk appetites and working those through with them is an essential first step to portfolio creation. "Many people build portfolios talking only about returns and the upside, but without enough emphasis on the potential downside and volatility," an expert observed. "In times of stress, that is when investors, me included, will let emotions take over that will then affect long term returns. And then, when you apply scientific portfolio allocation criteria, the next risk is that you use historical numbers, but that approach does not necessarily give you the right answer. So, what we do is actually to backtest or to analyse what would be reasonable forward volatility to expect, for example, given different economic environments. For example, right now, in the US, inflation is picking up, and we are trying to protect client portfolios under different scenarios and then hedge risks in different ways, for example, through diversification across different asset classes. More bonds and inflation-linked bonds could hedge against equity risks, or in an inflationary environment, we might have higher allocations to REITs or gold.

Asset allocation and portfolio curation is a continually evolving challenge

"Have there been any changes in terms of how we select products?" pondered a senior banker from a global US bank. "Absolutely. But if you were to ask me that question six months ago, or in six months' time or two years ago, then I'd gave you the same answer, as this is always subject to evolution, always subject to improvement and enhancements, as we learn more about the best ways to select managers and bring them through our process."

He explained that a key area of progress in the past five-plus years had been relating to ESG, which had become an increasingly important framework for manager

selection, whether for public or private markets and across all asset classes.

He reported the bank has a dedicated team whose entire KPI basically is to go out and find dedicated ESG managers. "We have been intently resourcing this area for some years now, to make sure we bring the best and most interesting ESG-leaning products for our clients, not just in the private banking world, but also on the institutional side, and also creating interest in ESG-focused fund of fund products as well for our clients."

DPM and advisory also require more careful and sophisticated curation of products and ideas than ever before

The same banker reported that they make similar efforts in building robust discretionary portfolios for clients, including generating interesting conversations with them on adding new strategies, leveraging a core-satellite approach, tactical and strategic allocations. "A satellite approach currently popular is thematic exposure, such as technology, healthcare, sustainable energy, and others. We have great conversations on these ideas, talking to clients about incremental strategies that might be of interest to them, building additional thematic exposures on top of well-constructed core portfolios."

Resourcing up manager selection is often core to private bank differentiation

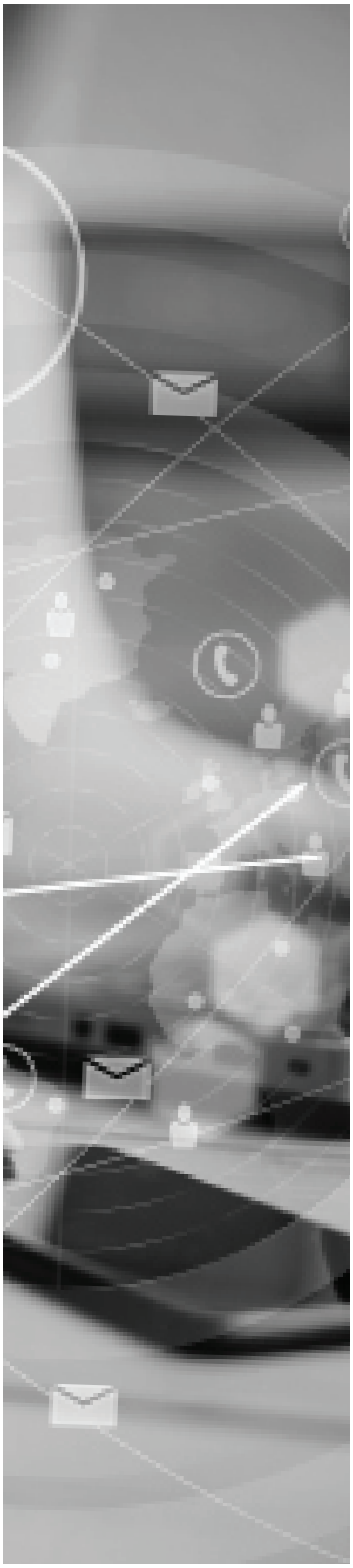
A senior representative of another global US bank reported that they are putting increasing resources behind manager and fund selection. "We have a team of 50 or more people purely focused on selection in itself, one of the biggest teams in this market," she explained. "And as we have a vast amount of assets in managed solutions – certainly one of the highest numbers on the street – we have unparalleled access to pretty much every fund manager across the globe. Accordingly, if there are any issues whatsoever, typically, we are the first to sit in their office and have a discussion with them. That also gives us a lot of leverage in terms of coming up with new strategies that are bespoke for our clients or exclusive to us. And of course, we are continually adapting to new regulations, new data, evolving our approach and due diligence all the time."

The IAM/EAM players lack the global banks' huge resources. So how do they cope with the increasing demands of asset, fund and manager selection?

A leading figure in the IAM community remarked that they obtain many fund recommendations from their custodian banks but are always on the lookout for what he called 'distorted incentives' in terms of marketing some sort of exaggerations, for example, perhaps of their ESG capabilities, and also as to the transparency of fund choice, to ensure that there is true objectivity in fund selection.

Independent wealth managers should beware of those 'distorted objectives' that tarnish manager and fund selection

Are some leading banks and providers are driven by factors



unrelated to performance when they select funds to put in client portfolios? "Yes, and in Asia, we know that fund houses are still allowed to pay incentive fees, whereas in the UK, for example, this is prohibited," an expert pointed out. "But at least there is greater transparency nowadays on this practice, so it is not necessarily deception, but due care must be taken. We leverage our decades of experience to help us assess, as we do not have the resources to bring lots of people to bear on this, so we adopt highly focused due diligence and do the deep dive on those funds that look interesting, even if they are not from the biggest asset management houses."

Leveraging group resources is vital for the portfolio curation process for many firms in Asia

The Asia-focused executive of a leading UK based wealth management firm explained that for due diligence of all types of funds and managers, including those driven by ESG metrics, the firm leverages its UK-based and global resources to analyse the managers from which to select strategies. "We then build on this for Asia to deliver more Asia-centric options, and then also communicate how market developments might be more relevant to the local client there," he told delegates.

In terms of ESG specifically, he explained that his firm does not simply look for the best ESG rating figure per se. There might, for example, be fund managers who invest in inefficient companies with a view to boosting the green credentials. "There could be inefficient energy companies that seek additional capital to turn themselves into greener businesses," he said, "and helping to provide the capital to improve such companies can make a significant difference, so these types of managers and target companies should also be on the radar."

And watch out for the seemingly sustainable companies that are far from sustainable

The same guest also observed that in his 20 years of watching ESG closely since it first entered the public view, there had been plenty of situations where apparently ESG compliant companies were anything but sustainable. These might have been biofuels companies that, in reality, often operated at a net energy deficit, and the only reason they continued to operate was due to government incentives, for example, from the US administration. Or they might be supposedly green companies taking the crops whose by-products then create biofuels, where to grow and cultivate the crops demanded deforestation on a massive and destructive scale, which would again be highly counter-productive.

Private investors should be wary of following their emotions; they should stick to data and reality

This same expert cautioned that people might look at all these issues emotionally, but actually, they should follow the data. He cited electric cars, for example, and urged investors to look at how the power is first generated to fuel those batteries. He pointed to how natural gas in China might help reduce coal and emissions and make things cleaner, even

though it is a fossil fuel. "But such a business may be deprived of funding precisely because gas is a fossil fuel," he observed. Another guest agreed that the end result must justify the ESG ratings and, therefore, that the transitional phases must be carefully assessed as well.

Moreover, he said a review of the typical top 10 holdings in ESG funds usually shows high exposure to IT companies. "However, although such tech firms might enhance efficiency and productivity, they might often pursue what can be considered unethical tax practices due to the way they can operate and structure themselves," he warned. "ESG proponents need to look at all the aspects of a company and not just ESG ratings. If you have a major tech company paying no profits, due to very fancy tax gains, those profits and theoretical taxes could be harnessed for good use to improve the environment."

Weighting the managers and the funds to round out portfolios

Another expert reported that their firm is always prepared to bring in new, smaller funds to add diversity the portfolios, across public and private markets and including long only and hedge funds. "We can put a newer fund, a newer manager in there with a shorter track record, a lower AUM, because we're in control of the percentage of that fund within the broader type of fund of fund portfolio we build," he reported. "Our process does not discriminate against smaller funds, but we keep an eye on whether they are generating the right level of revenue from the AUM to pay their people, to retain their talents, and so forth."

He explained that once they are comfortable with the fund and managers, their concern is more about whether the clients will want to invest in the fund. "The feedback that we get from our private banking clients, particularly here in Asia is they don't want to allocate meaningfully to small funds, because but we can bring them into a fund of fund structure, assuming all the due diligence goes as planned," he said.

Always be ready to advise clients against making certain decisions

A banker observed that part of the entire portfolio curation protocol must be the readiness and willingness to advise clients against making certain decisions. "Right now there is a lot of 'FOMO' - fear of missing out – but there are areas we strongly caution against, for example we are very much against our clients investing in cryptocurrencies," he explained. "Delivering good advice to clients is not only advising them what to do, but equally sometimes what not to do, or to protect clients against themselves. I mean, if you have a Hong Kong Chinese client based here with a strong bias for the local markets, wanting to plough all their money in accumulators on Alibaba and Tencent, you have to be firm about the risks and advise them accordingly."

The final word - DiligenceVault is there to help

Also in attendance for the discussion was Giulia Baiocchi, the Singapore-based APAC Director of Client Partnerships at DiligenceVault. She offered the final comment of the event. "This was a great discussion, and well chaired, thank you all, and my final comment is that we are open for business here in Asia, out of Singapore, and we are here to help." ■