The World of Private Client Portfolio Formation: Perspectives from an Asian Investment Advisory Specialist

Martin W. Hennecke is Head of Asia Investment Advisory at St. James's Place Wealth Management in Hong Kong. Hubbis met with him recently to learn of his current advice for private investors seeking to navigate the vicissitudes of regional and global markets. He argues carefully and logically for advisors and private clients to be highly discerning, favouring suitability, risk mitigation and diversification over following the herd. He maintains that the near past does not always reflect the near future, but says that taking a balanced, diversified and a longer and more historically inclusive approach to robust portfolio formation are all vital for the typical private client whose future well-being is so often closely linked to their adroitness in investing wisely.

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What advice would you give to private client investors on how to think about creating a long-term portfolio?

I'm seeing a lot of people struggle with this and it is important to avoid the typical pitfalls, which occur all too often from my perspective with 24 years in this industry.

Firstly, why are people making these common errors in the way they approach portfolio formation? I see two possible reasons – one is there can too often be recency bias, whereby people favour those things that have done well recently; they assume that will continue, and then they find justifications for that thinking.

Another reason is that people find some fancy idea or product and think it is too good to turn away; perhaps it is packaged so attractively that the client might forget about important basic principles of investing like diversification, thorough research and analysis etc.

Earlier today, I encountered an example that perfectly illustrates a common oversight in investment strategy. As the head of investment advisory, I support our Partners in providing suitable advice on client portfolios and overall allocation of assets. I was consulted about the case of a client who, through another firm outside of our management, had invested in a portfolio of just two funds, one being an Indian equity fund. This choice, however, stood in sharp contrast with the client's stated desire for a low-risk investment of utmost security with those monies: not only is a high equity allocation questionable here generally speaking, but clearly concentration to just one single emerging market is inappropriate.

Moreover, this situation highlights the risk of recency bias as well, whereby investors tend to be easily drawn to assets that have recently surged in popularity, often influenced by compelling narratives, in this case India's demographic and GDP growth and strong markets off late. Yet, what frequently gets disregarded in this equation is the factor of valuation, i.e the price paid for assets, which tends to be higher the more popular markets are. In other words, the allure of positive news headlines can lead investors to overlook significant risk factors such as the valuation of stocks, the danger of concentration risk and overconfidence when lacking diversification etc., underscoring a critical gap in comprehensive risk assessment.

As we saw during the worst of the early COVID-19 crisis, or the 2008 global financial crisis, many private investors tend to flock together, panic, and sell at market lows, which is arguably the worst possible reaction. Moreover, this pattern of behaviour isn't limited to general market movements; it extends to sector-specific and regional trends as well.

Relating this back to the aforementioned example, we have seen many investors asking about selling all of their holdings in China and shifting it to India, lured by the latter's perceived advantages. However, this overlooks the fact that the premium of investing in India over China is close to record highs, again underscoring the importance of unbiased examination and opportunity evaluation processes from a 360 degree perspective.

Despite the temptations to concentrate investments based on recent performances or news, we continue to advocate for deep analytical focus on the earnings, growth prospects, risks and price of individual businesses, along with diversification as cornerstones of a sound investment strategy. That is not to say that we have preference over any particular country, market or sector, principally speaking, and in fact we do still see some good opportunities in India as well, but blindly over-allocating to just the most popular markets or sectors, whilst discounting attractive opportunities that might be overlooked in less popular markets, can be unduly perilous and result in sub-optimal long term return outcomes.

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Does the wealth management industry sometimes, or perhaps too often, pander to this behaviour, and what is your particular approach?

Some financial institutions tend to capitalise on the allure of popular markets and products, driven by compelling narratives that easily capture investor interest. However, this approach can be misleading, as the risks associated with such investments may not be fully understood or effectively managed. This marketing strategy banks on the appeal of stories and features that sound beneficial on the surface but might conceal or distract from underlying risks.

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As one example, for an investor asking for market advise but who is very highly leveraged with mortgages, loans and/or credit card debt, best advise might be simply to deleverage rather than invest any further, and I would emphasise here that we should never be too overconfident about risk factors of investing including unforeseen ones that we might not know about yet such as COVID 19 coming out of nowhere previously.

Conversely, there are individuals who, out of concern for market volatility, might be highly allocated to cash or deposits. While this approach may seem safer on the surface due to the absence of day-to-day volatility, it overlooks the inherent risks associated with potential loss of purchasing power due to inflation and negative real interest rates which can easily be not recognised (or recognised too late) as a significant risk, as in the boiling frog analogy whereby very gradually increasing heat is not being felt as alarming, Accordingly, such clients might be best advised to consider investing at least some of such holdings if only as a means of inflation protection and accordingly risk diversification.

Some investors, by the way, may confuse the term negative real interest rates with that of negative interest rates. Let me give you an example of what I mean by this. Japan last month became the last country to exit negative interest rates, in absolute terms, announcing its first interest hike in 17 years from -0.1% to a whopping range of 0 to 0.1%. However, just prior to this, the country's largest union negotiated an annual pay rise of 5.25% which might well serve to entrench inflationary pressure. Accordingly, negative real interest rates, i.e. the gap between nominal interest rates and inflation, could actually widen, and it

would appear that Japanese households might want to be more mindful of the risk of purchasing power loss given that cash and deposits account for over 50% of their financial assets.

Negative real interest rates should probably be taken more seriously as an important risk by investors globally as well, particularly against the backdrop of large sovereign debt and budget deficits in many major countries.

This all sounds logical and eminently sensible, but it is often tough for private clients to properly assess all these moving parts and the numerous nuances clearly. How can they improve their 'vision', for want of a better word?

Yes, the traditional dichotomy of low risk versus high risk in investments isn't always as straightforward as it seems. For example, conventional wisdom suggests that certain assets such as developed markets sovereign bonds are supposed to be low risk at all times, yet we have just seen in 2022 that they can face significant drawdowns, and, as mentioned, cash, deposits and fixed interest can also all be vulnerable to inflation if it exceeds the rate of interest paid.

It is difficult to spot, and that's one of the reasons why I say that the key is not to look for just any one particular 'clever' investment product or fund only, but to aim for broad diversification across one's assets accounting for different types of risks. This approach isn't limited to an investment portfolio's composition but extends into any other assets including property as well, which could serve a dual purpose like providing a current residence/ future retirement home or acting as a diversifier and/or inflation hedge as well.

Choosing investment funds based solely on past performance is a common pitfall. Currently it may lead investors to funds that are heavily weighted towards US AI and technology stocks. Instead, the focus should be on adopting a forward-looking approach to investing, one that carefully considers current price versus future potential rather than relying on past successes. Another final point to sum this up is that it is crucial to detach emotion from the decision-making process, focusing instead on rational, strategic planning as opposed to over-reactive choices influenced by recent market movements, fund performance or public sentiment. True diversification means also considering potential within underappreciated markets.

How do clients actually assess who is doing a good job of helping them manage their portfolio or who they should be placing their trust in?

It is crucial to understand that the evaluation of investment success transcends mere performance metrics in terms of which funds or portfolio manager generated the highest returns in the recent past. The alignment of investments with an individual's objectives, risk tolerance, and financial planning needs is paramount, as is diversification - and true diversification means that it is highly likely not all assets will always perform well at all times. For instance, a conservative investor experiencing a significant rise from high-risk technology stocks may have been receiving unsuitable advice, despite the financial gain. This misalignment underscores the importance of suitability over performance in isolation.

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Moreover, considerations like currency risk further complicate the decision-making process. A scenario involving a client preparing for retirement in the Eurozone, with all his or her assets in USD, highlights the potential for undue currency risk. Such oversight in aligning the investment strategy with the client's risk tolerance, time frame as well as future currency needs illustrates the nuanced aspects of sound financial advice.

Additionally, the risk and volatility associated with different investment strategies warrant careful scrutiny. I would like to share the example of a hedge fund that was very popular in the market having performed consistently well over many years, including during the financial downturn of 2008, only to incur a 78% loss in a single day due to a major volatility event. This case exemplifies the critical need to assess the underlying risk management strategies of investment options, beyond their historical performance or the allure of their returns.

In summary, choosing between different investment firms or strategies should not just be a matter of comparing percentage returns only to imply success or failure. Instead, it involves a comprehensive analysis of how well each option aligns with the investor's goals, risk tolerance, and specific financial circumstances, including currency implications and inherent risk management of the investment strategies employed.

How do you approach all these issues in your daily dealings with your product providers, your own advisors and your clients?

As a firm that selects and collaborates with a wide array of investment managers, both passive and active, we face the challenge of discerning which managers align with our investment philosophy and the needs of our clients.

A recent seminar with an emerging market equity manager shed light on the evolving dynamics of investment popularity and value assessment. Emerging markets, once celebrated from 2000 to 2010 for outperforming the S&P 500, are now largely shunned by investors as they subsequently underperformed the US since 2010, but in our view do offer some attractively priced opportunities currently.

This fluctuation in popularity and performance highlights the importance of maintaining a diversified asset base and being wary of market trends that can lead to disproportionate emphasis on specific regions or investment styles. In early 2022 Emerging Markets (EM) as a region and also Value as an investment style were both highly unpopular, but it was then that we decided to balance our EM positions more evenly between growth and value by adding a new value focused EM strategy following multi-year outperformance of growth. The manager selected for this mandate was very positively surprised at being approached due to the unpopularity of their investing style at that time, and subsequently demonstrated great resilience and performance through 2022 and onwards. This demonstrates again that manager selection should not be guided only by pure recent performance considerations only, as it can result in overlooked opportunities by investors, and it underscores the potential of contrarian strategies in navigating the complexities of global markets.

This approach, rooted in careful analysis and a willingness to explore out-of-favour opportunities, illustrates our commitment to crafting investment strategies that are resilient, diversified, and attuned to the shifting landscapes of global finance.

Navigating the complexities of investment management involves making subtle decisions about the selection and continuation of partnerships with various fund managers. The challenge often lies not in the immediate performance metrics but in understanding the underlying strategies that may influence outcomes over time. For instance, a manager's emphasis on a value, growth, or quality strategy and their regional market positioning can significantly impact performance, especially in contexts where certain markets or sectors might temporarily have moved in our out of favour.

Success in this field is as much about understanding the reasons behind the numbers as it is about the numbers themselves. It's essential to evaluate whether a manager's performance results from genuine skill, effective team dynamics, or merely temporary market conditions that align with their strategy. This discernment requires a keen understanding of market nuances and a long-term perspective on investment outcomes.

The crux of making informed decisions in this domain is to dig deeper than the superficial allure of high past returns, high dividends being artificially derived from capital or other trendy product features, which can give rise to misconceptions about suitability and future return expectations. ■