Private Banking: Roundtable - A closer look at wealth management business models
Publication: Professional Wealth Management (PWM)

ByLine: Yuri Bender
Publication Date: May 01,2009

Opinions from the inside

New business models roundtable, 16 April 2009, Roundtable participants:

Mike Bussey, CEO, Arbuthnot Latham

Humayon Dar, CEO, BMB Islamic

Adrian Gayler, Head of Private Banking, Bank of London and the Middle East

Daniel Gerber, CEO, Julius Baer International, London

Marc McCarron, Chief Investment Officer, SEI Investments

Gavin Rankin, Head of UK Products and services consulting, UBS Wealth Management

Tom Slocock, CEO, Private Wealth Management (UK), Deutsche Bank

Sally Tennant, UK CEO, Lombard Odier

Venky Venkatesh, Director, Private Wealth Management Solutions, Oracle Financial Services

Yuri Bender, Editor in Chief, Professional Wealth Management

Yuri Bender: The noises from Zurich are that allocations to alternatives, to hedge funds in particular, are decreasing. Is that the experience in London?

Gavin Rankin: Clients have lost a lot of faith in real estate and hedge funds, for various reasons. Typically, when a client walks through the door, we go through a risk profiling exercise, where we focus on liquidity as well as tolerance for unregulated investments. Through that fact finding, we end up at a solution, over which there is also a qualitative overlay in terms of the dialogue with the client. So there is a road map and a route. It tends typically to be driven by the client, but we still suggest they use alternative asset classes within their portfolio. The more asset classes and the more diverse they are, the better the outcome for them, but if the client has strong opinions and is not prepared to tolerate unregulated investments, they end up in a three asset class solution.

The UK solution uses a 20 per cent allocation to hedge funds. If you were to optimise a portfolio using historical and forward looking data, your hedge fund allocation would be significantly higher than this, so we cap it at 20 per cent. Real estate is another 10 per cent, so we are looking at portfolios multi asset class solutions in the UK with a 30 per cent allocation to alternatives. Given the market environment and what we have learned from some asset classes, we think alternatives still have an important role within client portfolios. It is very important to look away from the noise about why hedge funds are included in portfolios. We include them because they are a great source of diversification and of return, and for capital preservation. We still believe they are fundamental building blocks of any asset allocation solution.

Daniel Gerber: Our clients' focus is on wanting to understand more of what they are invested in. They do not like to be invested in things they perceive as 'black box' and not to be able to see what is going on inside. What we see at the same time is that new clients are mainly investing in cash. The ones invested in hedge funds and alternatives want to get out as soon as possible and go into the basic building blocks and things they understand.

Yuri Bender: Will we finally see a move to a passive core in the wealth management industry?

Sally Tennant: To a certain degree, it has already started. For making tactical moves, having exchange traded funds or passive exposure makes a huge amount of sense, but it depends on people's investment philosophy and process. If you are very tactical and believe it is all asset allocation and that you cannot add value at stock selection level, you will probably have more passive exposure. On the other hand, if you have fewer tactical moves and take two, three or four year views, you are more likely to have active managers or spend time finding managers who will add value bottom up.

Gavin Rankin: I would strongly resist putting a large part of a client's core long term asset allocation in exchange traded funds. As a house, we still believe strongly in active management in the core, but active managers per se are not the be all and end all. You must have a process that consistently identifies active managers. The evidence is that active managers outperform, but that it is very difficult to identify those managers. We would certainly echo Sally's point about ETFs being used in tactical asset allocation. It makes sense for clients. If you are taking a tactical asset allocation bet, you do not want manager risk as well as country risk. But we still invest significantly in a strong manager due diligence function, and I imagine that will continue to be the core of what we do.

Marc McCarron: On the idea of core/satellite and putting more money into core, it seems cheaper to do that, but it also depends on what the satellite is. Ultimately it might be a reaction to today's markets that might mean giving up on some active management and paying a little less money, but unfortunately, the risk associated with that satellite will still drive your relative return against that core. It might not solve the client's problem of wanting more consistency in the return. In our view, there is a flaw in core/satellite.

All you are doing at the core is damping down some of the active risk, but you are still taking it to some degree. Depending on what that active risk is whether it is a hedge fund, a commodities allocation or something very satellite it will ultimately be the pure driver of your risk, and you cannot offset that just by having a passive core. There may be a better idea involving using a core strategy but trying to balance satellites almost to bring a core at the portfolio or strategy level. Using core/satellite, it is difficult, in our view, to capture the end result for the client.

Tom Slocock: It is often more challenging if you have core assets combined with lots of different satellite approaches. It is sometimes more difficult to hedge your satellite risk effectively, but at least you are identifying more closely what risks you are taking and limiting those specific risks. One of the attractions of core/satellite is that you can effectively use beta in your core and put more of your resources to work selecting managers and products that give you real alpha in the satellites. You will know what that core of 50, 60 or 70 per cent of your portfolio is going to do, allowing you to target opportunities for alpha where you think it is most likely to be available in the satellite investments.

Adrian Gayler: As BLME is a Sharia based bank, I cannot include hedge funds from the alternative world, so the dialogue I am having with clients about the more illiquid components of their assets has narrowed, but that does not mean they have changed their expectations of returns, so there are some additional challenges. Interestingly enough, a lot of the dialogue on alternatives is starting to focus on private equity, specifically since we find that some clients feel that the more they know about a company and the more influence they can have, the happier they may be about the risks they are taking. It may sound a bit counterintuitive considering some of the dialogue we are having, but although they may be slightly illiquid and very long term, clients seem to find a level of comfort in this, which appeals to them.

It is quite interesting, although not from a fund perspective per se that would be a challenge for us, as it is early in the cycle of Islamic finance but on a club basis, say, where you can get together 20 significant clients at a certain investment level: let us say $5m (EU3.8m). When they get together, it is almost like building a business model and a solution from that client set. They say, 'That ticks one box in my total allocations.' Although I don't like to say 'back to basics', it is that sort of approach: saying, 'Well, this is not so much product driven as solution driven'. We must go right back and say, 'What is it these clients are asking of us, and how do we come up with a solution when a number of things available to conventional institutions are off limits?'

Humayon Dar: We have been considering hedge funds, private equity funds, real estate transactions and, of course, ETFs as well. In the last 18 months to two years, Sharia compliant investors' expectations have changed completely. We have been working on a product called the Share platform: sharia alternative return evolution. Initially, we wanted about 40 per cent of assets on the platform to be hedge funds, about 20 to 30 per cent private equity and the remaining amount in other asset classes, including commodities. Now, after going back to the market, we have realised there is a complete shift away from hedge funds. Sharia compliant investors would not like to expose themselves to hedge funds, primarily because of hedge funds' negative publicity, and there are of course some Sharia concerns about hedge funds as well.

We have observed lately in sharia markets a preference for commodity futures managed programmes. Basically, one fundamental preference remains in Islamic markets: high return. Some managed futures programmes have generated huge returns of 20 to 35 per cent. These are the kinds of return Islamic investors are looking for. Hence, in our Share platform, we have decided to increase the percentage of commodity futures managed programmes. ETFs are a new area, and a few products are already on the market. I believe this is something Islamic investors would consider, if ETF programmes came up with some kind of capital preservation as well.

One area that has developed rapidly in the last three years is structured products, many of which offer capital preservation. I think the future expansion of Islamic markets will be in structured products. In the beginning, when Deutsche Bank started an Islamic structured programme, there was criticism from a sharia viewpoint, but now almost all investment banks into Islamic banking and finance have their own Islamic structured programmes, and sharia problems concerning them have gone away.

Mike Bussey: What we are hearing from clients is scepticism about active management and product driven sales. There is more worry about the cost, and therefore value for money and about anything not transparent in structure, whether it is structured products, funds or hedge funds. What we hear about hedge funds depends on how they have been 'sold' and what their role is in the structure of the portfolio. Many investors will have bought hedge funds in the expectation of absolute return, capital protection and lack of correlation, not that they would specifically outperform equities. Therefore, we are seeing that hedge funds absolutely have a role. Direct access to good managers is important, but there is less appetite for funds of hedge funds, given cost and transparency issues.

Clients are receptive to the core/satellite argument, not just on the obvious basis of cost, which keeps coming up, but also because it is more transparent. The fact you can see exactly what sits within an ETF, unlike other, closed funds, is important, as is increasing breadth across asset classes. The fact that they can be traded intra day also plays well and they can increasingly play a part within the active allocation. We must be conscious of what has happened to clients over the last 12 months. The norms of our world have been challenged and found wanting. Listening to clients and the emotion coming out is important, and we must respond to that. There is a danger that we as an industry can pontificate a little too much to clients about what is good for them. We have to do a lot more listening and react to it.

Yuri Bender: Is multi-manager a good business model that can easily inserted into smaller private banks that do not necessarily have a huge asset management capacity?

Marc McCarron: It is a business model and approach quite attractive to smaller and less developed private banks that want to provide that capability but might not have the resources internally to do so. However, it is critical those who decide to offer this understand they are giving ownership of a lot of those decisions to someone else outside the bank. Asset allocation strategy, product or manager selection, accountability and due diligence are outsourced to some degree. We found that a critical aspect last year, obviously: who is doing your due diligence, and are they doing it right?

In many ways, although you might have capability internally at the bank, a specialist organisation such as ours has found at least some buy in and connection with others that want to offer best of breed, if they can, but do not have the capability, do not feel able to take on the risk and ultimately leave it to someone else. That said, we try to work closely with our clients to ensure they understand the nature of what we are investing in and the strategies that we have built so that they feel that it is their product and not someone else's. If that breaks down, then we are just a provider of product, not a solutions provider, which is what we aim to be.

Yuri Bender: We have talked about a large number of products and solutions: multi manager, off the shelf funds, structured products, hedge funds and ETFs. How easy is it for one technology provider to provide back-up for all of these strategies and look after the technological outsourcing needs of a private bank?

Venky Venkatesh: Although customers are looking at a product that can provide them with multi asset capability and maybe with front office, middle office and back office capability, we see that most of the usage and demand involves quickly getting a front office solution. Primarily, that is because, if we look at the market trend today, customers are demanding transparency. Number one, I want to see that I am getting the return that you promised me. Number two, customers think they are more intelligent than they were, so they think that they can look at their investments and at the risk profile of their investments and at least make some judgment about them. There is demand for products that would, ideally, cover front office, middle office and back office. When I say front office, I mean client facing client relationship management ability. When I say middle office, I am talking about locating products, looking at their performance, trading and that kind of thing. At the moment, we see banks investing in client facing solutions, allowing them to talk to the client and make them feel their requirements are understood and the product is being tailor made for their risk profile and investment horizon.

Banks are also starting to use financial planning to give the client comfort: 'We are working with you to create this product.' The second trend is that many banks want to offer client access or a client portal where they can see their performance remotely without having to come to the bank and ask. They like to have confidence that the bank is providing the return promised, and they like to be on top of things. They like to see it from wherever they are, by logging in or communicating with the relationship manager through various channels.

It could be via the platform itself, by PDF or by SMS, where they get automatic alerts from the system saying, 'You have put in some conditions in your investments, and this is what has happened to them.' They like to receive alerts. Clients like to be on top of what is happening and what the bank is doing with their investments. Are the returns happening? They have been promised returns. Banks' clients are demanding access to their portfolios to view their performance, and they want easy communication with their relationship manager, whether they are in the country or outside it. That is the kind of provision that people are looking for in a technology platform.

Yuri Bender: Should you hive off the technology platform to the back room boffins, or should it be seen as a key part of the business model?

Mike Bussey: Technology is hugely important to successful client delivery. The ability for clients to access information in a timely way, accurately and with an umbrella view is crucial. It is also a bit of a holy grail. I am not sure anybody has actually cracked it yet. At the ultimate umbrella level, you are still looking at cementing together a whole pile of information from different sources. I do not think there is a seamless answer out there at the moment.

Yuri Bender: Swiss banks in particular have come under attack by the G20, the OECD, Barack Obama and various other powers that be. Is it now more important to diversify globally with onshore operations in a number of countries? Bearing in mind that the balance of world wealth has swung more towards emerging economies, how important is the UK business within that model?

Daniel Gerber: We are a niche player, and that is what we want to be here in the UK as well. We have other growth areas, notably the Middle East and Asia, where the footprint is very different, especially in Singapore, where we have a fully fledged bank that has grown strongly. But of course we do not want to give up on traditional and strategic places such as London, where we have been present for such a long time.

To expand on the onshore or location part of your question, the Julius Baer Group's business model remains offshore banking. Where we have onshore locations, it is because the market is interesting and big enough for us to have a slice and make an onshore representation profitable, as in Germany. Whereas in the UK, for example, we do not book our assets here, so in a way, we still use the offshore model. All our assets out of London are actually booked in Guernsey, Switzerland or Singapore, so it is still the offshore model, but with local representation. That is pretty much the case for all other locations except Singapore and Asia. How that will change with regard to the most recent increase in pressure from the European Community and the G20 remains to be seen.

It is a very dynamic environment at the moment, and it remains to be seen how we will adapt to developments, but personally, I think Swiss banking secrecy is not dead and will never be. The protection of legitimate privacy is one of the core values of the Swiss banking system. There will be ways to fulfil the requests of the G20 and countries that want more information about clients without actually having to give up client confidentiality: For example, European savings tax could be expanded as a model. That is probably the way forward.

Yuri Bender: How will wealth management business models change in the next few years?

Tom Slocock: A number of things we talked about, as well as the current financial pressure on the industry, will make a lot of players rethink their business model and level of commitment. If it really is a requirement to have a credible presence local to your client, whether in the Middle East or within the regions of the UK, that will require significant investment and a rethink for many players. We may well see a divergence in terms of the market players, but at the moment, some people are re-examining how they do business.

The focus at the moment is probably more internal than external. Rather than a focus on how things will look in five years' time, there is a certain amount of focus on how they will look like by the end of this year.

Sally Tennant: Looking back at what has happened in the past 18 months there are three key things driving thinking at the moment. Transparency is one of them. From G20 to the regulators down to clients wanting to understand their fees, transparency is really big, and we will have to work harder on it. Risk is the second one. Most people were let down by portfolio construction last year, except those in cash and bonds. How portfolios are constructed and how you look at risk and return needs revisiting. Ensuring that we provide value for money is the third issue that we, as CEOs, should all be concerned about.