

FEATURE WEALTH MANAGEMENT

Changes are afoot that will likely lead to a sea change in money management. Core wealth management funds have flexible asset allocations and are designed to keep out of bad markets and stay in good ones

Wealth management is about to change

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It is fair to say if investors or their financial advisors did not catch the biggest crash in global assets since the 1930s, they probably will not catch the next one. In fact, most investors and advisors were not even trying to avoid a market collapse like this latest one. Most assumed shocking falls across worldwide stocks, bonds, real

estate and commodities were rare or unlikely to last, and so subscribed to a 'buy and hold' philosophy. Others thought by holding hedge funds, private equity and other such alternative investments they would be safe from harm. They filled their portfolios with collections of alternative assets that would be uncorrelated with markets.

For investors, the past decade and the past year have probably been a revelation: fresh ideas are afoot that will likely lead to a sea-change in money management. Investors, in order to capture their targeted returns, should not have to buy and hold assets and should not have to lose access to their capital through lock-ups.

Wealth management is undergoing a paradigm shift. In addition to 'buy and hold' and to 'alternatives', investors will want to hold 'core wealth management funds' with flexible asset allocations designed to keep out of bad markets and stay in good markets. What will 'core funds' look like? They will allocate client money globally, reduce or raise their clients' market exposures with meaningful tactical shifts, and use formal investment processes to make decisions. They are likely to participate in markets through liquid, large-capitalisation securities such as ETFs, and be themselves regulated, providing daily dealing with no lock-ups for clients.

The buy and hold paradigm

'Buy and hold' is no longer the one and only investment paradigm for long-term investing. Other than being easy to explain, how did it become so prevalent? 'Buy and hold' allocations mean matching the investor's risk tolerance to a portfolio with fixed weights for equities, bonds, commodities, real estate, cash and alternatives, holding it for the long run, and rebalancing now and again when the markets go out of kilter. This approach was remarkably successful from 1982 to 2000, as the US Fed Funds rate went from 20% in 1981 to less than 5% in 1999.

Long duration securities got such a boost from lower interest rates that equity markets outperformed major asset classes worldwide; and investors could smooth rising returns by holding some cash and bonds, but the higher the market risk the higher the returns. The Berlin Wall fell, the Soviet Union imploded, and China opened during the 1989-1993 period, giving markets another lift. Why should investors ever need to sell shares? Whatever the worries in October 1987 or September 1998, the long-term cycle would bail out global stocks.

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meant paying heavily to play the long term through fixed market allocations. Nonetheless, the recovery from 2003 seemed to justify the investment paradigm for those with high enough risk tolerance. Yet the 2007 to 2009 crash, the worst since 1929, meant the 107 US state pension funds lost on average 37% in the 14 months to Dec 2008. All the nominal gains for Norway's sovereign wealth fund over the past 12 years have evaporated. The world's biggest funds officially have cut equity allocations going forward. 'Buy and hold' allocations are clearly not the be all and end all of investment, if only because getting the needed results for investing over the long term probably means waiting for much longer than most clients can bear.

The alternative basket paradigm

Alternative investing does not look as appealing, or even as alternative, as investors had hoped over the past decade. The idea behind holding a basket of alternatives is to give up the investor's access to liquidity and transparency by locking up the money, putting it in hedge fund strategies, private equity and alternatives in order to get higher returns and, most importantly, investment returns that are not tied to rises and falls in the markets.

The strategy worked very well from 2000 to 2007, when Ivy Portfolios with half or more in private equity and alternatives not only did not tumble with the markets, but had enough leverage to falling

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interest rates and corporate spreads over the period to provide substantial gains. This all fell apart with the crash in corporate bond markets and record widening of spreads begun in 2007. Spectacular private equity wins turned to dramatic losses, with no access to their capital for investors, and many hedge fund strategies turned out to be leveraged plays on market direction, capable of falling 20% or more in 2008. Harvard announced last month a one-third drop in its endowment over the 12 months to June 2009, with remaining unfunded private equity commitments as high as another one-third. The Ivy Portfolio approach to markets has serious drawbacks of its own.

Core management: a new paradigm?

Investors in the future also will hold 'core wealth management funds' with flexible allocations to preserve their capital in bad times and to capture returns in good times. Global markets will evolve to provide more and more low-cost, high-liquidity securities such as ETFs by which to hold asset classes cheaply and cleanly. Exchange traded funds and notes already give direct access to commodities, precious metals, real estate, corporate bonds, technology shares, small-cap shares, value stocks, growth stocks, global sectors, emerging markets and major equities. More and more hedge fund strategies, private equity and alternatives are offered in daily-dealing, liquid, highly transparent form. As investment paradigms evolve, investors doubtless will be including 'core funds' in their portfolios. Core wealth managers will invest across global assets, use flexible asset weights to control risk, and buy highly liquid underlying securities to provide ease of access and transparency.

THIS ARTICLE IS THE FIRST OF A THREE-PART SERIES DEALING WITH ISSUES AFFECTING THE WEALTH MANAGEMENT SECTOR

