THE NEW ASSET ALLOCATION PARADIGM

Pan-European Wealth Management Research

STATE STREET GLOBAL ADVISORS.
# The New Asset Allocation Paradigm

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FOREWORD

True investment management success goes beyond just producing returns. It is also about helping investors achieve their individual set of long-term goals.

We have previously revealed the common dislocations that can occur when making investment decisions, particularly when it comes to short-term versus long-term goals (see *The Folklore of Finance*). We believe that it is financial advisors and wealth managers, therefore, who play a vital role not only in supporting the financial well-being of millions of investors, but also in helping shape the values of the financial industry.

In this joint research report from State Street Global Advisors and independent strategy consultants INDEFI, we are delighted to share with you our in-depth analysis into the unique trends and challenges currently facing wealth managers across Europe. Against a backdrop of changing demographics and increasingly complex markets, the research aims to provide wealth managers with a context in which to navigate the shifting landscape. How are client profiles evolving across Europe? How are wealth managers approaching asset allocation predicaments? What are the new communication challenges facing wealth managers? We explore all of these questions and more.

We hope that you find the results interesting, insightful and practical. It is an exciting, as well as challenging, time for the wealth management industry, and as it continues to evolve apace, we look forward to supporting advisors along this journey.

*Rory Tobin*

Executive Vice President, Head of European Distribution
State Street Global Advisors

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*The Folklore of Finance* was published by State Street’s Center of Applied Research in November 2014 and is available for download at: statestreet.com/ideas/articles/folklore-of-finance.html
EXECUTIVE SUMMARY

Wealth managers across Europe are facing unprecedented challenges. Increased volatility across all asset classes in the five years since the global financial crisis has created a dislocation between existing client profile definitions and clients’ financial objectives.

Clients’ objectives have not changed: preservation of capital is paramount, while expecting returns that do not underperform the market. Yet in this new world where volatility is the “new normal” and where the risk-free rate has vanished – with even government bonds carrying higher risk but not necessarily better returns – wealth managers have had to fundamentally reassess their approach.

Our research has shown that wealth managers’ models are evolving across three key areas: client profiling, portfolio and risk management, and client communication.

Client Profiling
The necessary evolution required for client profiles is perhaps the central, and most logistically complex, challenge facing wealth managers. Client profiling remains at the heart of the discretionary portfolio management (DPM) service. But in the new environment, the existing profiles no longer translate investors’ risk appetites and return expectations into appropriate asset allocation boundaries. Even prudent/conservative portfolio profiles are now accompanied by higher risk. With interest rates at historic lows, negative returns are a real possibility in bond-heavy portfolios.

The traditional type of profiling by asset allocation boundaries is therefore too limiting and no longer relevant. So how are wealth managers dealing with this dislocation? We see one major tactical evolution, and one major structural evolution taking place. Tactically, wealth managers are using more flexible management styles to better manage market risk within the existing profiles. They are also moving clients to higher risk profiles which has helped lessen the urgency to build new profiles. However, structurally, wealth managers are also creating a new generation of client profiles, namely, absolute return profiles - a huge undertaking.

Portfolio and Risk Management
As a result of the need to manage portfolios in a way that meets clients’ capital preservation and return objectives in the low interest rate environment, the following strategies have become crucial to wealth managers:

Diversification, in both the fixed income portfolio and the performance portfolio. To remain within asset allocation constraints, wealth managers are diversifying within the fixed income asset class itself in terms of geography (US credit, emerging debt, etc.) and sub-asset classes (high yield, covered, etc.). They are also using shorter-duration products to help manage interest rate risk. The profile of the performance portfolio is also changing, with managers increasingly seeking other sources of performances to equity (within liquidity constraints), such as real estate, private equity and alternative funds.
Increased flexibility and tactical ability. In the search for reactivity, wealth managers have had to make maximum use of the flexibility allowed between the asset allocation targets set for each client profile.

Increased use of ETFs and pooled funds. ETFs are increasingly the vehicle of choice to implement tactical asset management. Moreover, their cost efficiency, transparency and ease of use have made them an attractive strategic tool as well, with many managers opting to use ETFs in core allocations as part of a “building block” approach. Notably, ETFs now make up 11% of total allocations to pooled funds. In addition, new fund strategies, such as advanced beta and multi-asset class, are also increasing.

Meanwhile, managers are increasing the focus on portfolio risk management alongside moving clients to higher risk profiles. The rise in absolute return profiles, where risk agreements are an integral part of the legal contract between the client and the DPM, has also contributed to the increased focus on risk.

Client Communication
Underlying these areas of change are increased pressures for better client communication, which is fast-becoming the “holy grail” for wealth management success, particularly in light of increased client demands for transparency. This emphasis on more effective communication also points to a key cultural shift since the pre-crisis years: wealth managers have put clients back at the centre of their business after years of restructuring.

The following report reveals how wealth managers across Europe are evolving their strategies to better align client objectives with their own business models.
After several years of turmoil post-crisis, discretionary portfolio management (“DPM”) services have picked up with vigour at all private banks across Europe. These are anticipated to further expand with the forthcoming implementation of MiFID II across the continent, which is expected to lead wealth managers to focus on differentiated value-added services eligible for direct remuneration by high net worth (“HNW”) clients.

Discretionary portfolio managers today are faced with the dual challenge of preserving clients’ capital while meeting their return expectations in a period of minimal interest rates. This demand, at the core of the DPM offering, is changing the way discretionary portfolio managers deliver their services to HNW clients.

This research report aims to provide a pan-European analysis of the main trends in this area, including:

- The characteristics of wealth management offerings in Europe and how they compare across countries
- The evolution of portfolio management strategies and asset allocations
- Client communication challenges.

The research is based on in-depth interviews with 60 wealth managers across nine countries in Europe, broken down into six geographical areas. As of 31 December 2014, these institutions managed total assets in excess of €2,800 billion on behalf of private clients.

The project was conducted over the fourth quarter of 2014 using the proven INDEFI market research methodology based on quantitative as well as qualitative information obtained from individual interviews with senior investment decision-makers at solicited institutions.

As is customary in our approach, all quantitative data gathered during the interviews has been systematically aggregated in the report and the anonymity of respondents respected. Only the country location of the institution is mentioned in order to enable pan-European comparisons.

INDEFI would like to thank all participants in this research for sharing with us their valuable market insight.

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2 To ensure consistency of the analysis, all interviews were carried out with representatives from the discretionary portfolio management desks of the solicited institutions. The latter include private banks (independent or affiliated to larger banking or insurance groups) and independent wealth managers (including registered investment advisors in Germany). Throughout the remainder of this document, we interchangeably use the words “wealth” and “discretionary portfolio” managers for the sake of simplicity.
Structure of the INDEFI Research Panel

The INDEFI research panel includes 60 wealth managers equally distributed over six different European regions:

- Benelux
- France
- Germany
- Italy
- Switzerland
- United Kingdom and Ireland (combined)

Assets in DPM and Panel Representation

As of Q4 2014, the wealth managers included in the panel manage more than €2,800 billion, of which €621 billion is in discretionary portfolio management. This line of business thus represents 22% of the total assets participating institutions manage on behalf of HNW clients.

The high share of DPM assets in the UK and Ireland can be explained by our focus on local independent wealth managers which primarily operate in this field of business.

Overall, the panel representation in asset terms can be estimated at 45% of the total amount managed in DPM by wealth managers in the six regions/countries analysed.

In terms of the size of DPM businesses, our panel displays significant differences worth highlighting. Most institutions manage less than €5 billion in DPM. The larger operators (over €20 billion in DPM) are found in Switzerland (hence the geographic bias displayed on Figure 1), followed by the UK and Benelux. Italy has only “small” DPM operators (i.e. less than €5 billion each in managed assets).

Figure 1: Structure of the Research Panel

(Total assets under management)

<table>
<thead>
<tr>
<th>Region/Country</th>
<th>Total AuM</th>
<th>Assets in DPM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benelux</td>
<td>199</td>
<td>111</td>
</tr>
<tr>
<td>France</td>
<td>1,978</td>
<td>291</td>
</tr>
<tr>
<td>Germany</td>
<td>402</td>
<td>53</td>
</tr>
<tr>
<td>Italy</td>
<td>384</td>
<td>39</td>
</tr>
<tr>
<td>Switzerland</td>
<td>2,424</td>
<td>103</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1,841</td>
<td></td>
</tr>
</tbody>
</table>

*INDEFI panel DPM assets as a percentage of total DPM assets in each region/country except UK & Ire. (excluding Ireland).

Source: INDEFI analysis; Investment Management Association.

Figure 2: Participating Institutions Ranked by the Size of their DPM Business in Each Region/Country

Number of Respondents

<table>
<thead>
<tr>
<th>Region/Country</th>
<th>Number of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td>60</td>
</tr>
<tr>
<td>Benelux</td>
<td>10</td>
</tr>
<tr>
<td>France</td>
<td>10</td>
</tr>
<tr>
<td>Germany</td>
<td>10</td>
</tr>
<tr>
<td>Italy</td>
<td>10</td>
</tr>
<tr>
<td>Switzerland</td>
<td>10</td>
</tr>
<tr>
<td>UK &amp; Ire.</td>
<td>10</td>
</tr>
</tbody>
</table>

3 Including five in Belgium, three in Luxembourg and two in the Netherlands.
4 Eight in the UK and two in Ireland.
This section reviews the key steps taken by wealth managers in constructing investment portfolios and asset allocations on behalf of private clients, taking into consideration investment constraints and objectives (return expectation and risk tolerance). These parameters drive the definition of the investor profile.

The Five-Year Investment Horizon is the Norm
The main constraint in the construction of asset allocation models is the client’s investment horizon. The average investment horizon among our panel is between five and six years (see Figure 3). Whereas investors’ long-term horizons are a dominant feature in Germany, short-term expectations seem to be more relevant in Italy.

“One has to consider that many of the clients in the wealth management segment of our bank are 60 and older. Therefore their interest is in preserving wealth for the next generation. The investment horizon for the majority of our clients is above ten years.” (Switzerland)

The investment horizon constraint has a direct impact on asset allocation. For instance, the decision to use asset classes such as equities or alternatives will typically depend on a minimum outlook of several years.

Characteristics of DPM Offerings and Asset Allocations in Europe

Figure 3: Investment Horizon in the Different Regions/Countries

<table>
<thead>
<tr>
<th>Region/Country</th>
<th>Three to five years</th>
<th>Five to 10 years</th>
<th>More than 10 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td>10%</td>
<td>44%</td>
<td>46%</td>
</tr>
<tr>
<td>Benelux</td>
<td>11%</td>
<td>44%</td>
<td>45%</td>
</tr>
<tr>
<td>France</td>
<td>10%</td>
<td>50%</td>
<td>40%</td>
</tr>
<tr>
<td>Germany</td>
<td>10%</td>
<td>30%</td>
<td>60%</td>
</tr>
<tr>
<td>Italy</td>
<td>10%</td>
<td>70%</td>
<td>30%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>10%</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>UK &amp; Ire.</td>
<td>10%</td>
<td>40%</td>
<td>60%</td>
</tr>
</tbody>
</table>

Average Investment Horizon: 5–6 Years
Longest: Germany 20% have an investment horizon of more than 10 years
Shortest: Italy 70% have an investment horizon of less than 5 years

The Limited Role of Asset Liability Matching in DPM
Asset liability matching is not a significant portfolio construction factor in DPM. It is primarily used by client relationship managers to allocate investors to a specific risk profile, taking into account identified constraints that the client may face during the course of the mandate (e.g. expected cash outflows, short-term investment projects, life events). This approach represents the extent to which asset liability constraints are currently taken into account in the DPM business.

As in traditional asset management, asset liability matching is however implemented for “semi-institutional” clients (e.g. small-size non-profit institutions) or, sometimes, in large, specific, tailor-made portfolios for private clients.

“In my opinion, profiles, and therefore asset allocations, should be more correlated to the personal objectives of the client with a real time horizon and with a real planning in a ‘life cycle’ approach. But the problem here is training the advisors and also the clients. A second problem is implementing these strategies in a cost-effective manner. They could only be applied to large portfolios. We are then moving into the semi-institutional space.” (Italy)
Capital Preservation is the Wealth Manager’s Main Objective

The main objective of wealth managers is capital preservation (see Figure 4). This is true for most respondents, whether capital preservation is defined in strict terms or as generating minimum absolute returns for their clients (generally expressed as inflation-plus returns).

There are differences among countries which need to be highlighted. While German wealth managers clearly prioritise capital preservation as their raison d’être, operators in the UK and Ireland typically tend to define their business in a more dynamic way (such as in terms of capital growth or maximisation of performance).

Overall, in the eyes of wealth managers, the focus on capital preservation has increased since the global financial crisis. It is worth noting that capital preservation is not just the preserve of “old money” clients. Even younger HNW individuals, often entrepreneurs, are looking for security over performance.

However, achieving minimum returns clearly appears to be a challenge for most wealth managers in the current financial environment as clients are still used to pre-crisis 3–5% per annum risk-free (or assimilated) yields on standard investments (e.g. life insurance, money market). In this report, we analyse how wealth managers are adapting their approach to reconcile their clients’ objectives with current market constraints.

Only a minority of wealth managers have investment objectives akin to more traditional asset management objectives (i.e. beating a benchmark — usually of composite nature).

“Our main objective is to outperform the benchmark which we have set with our clients. We define the benchmark with them based on their risk profile. We do not make capital preservation an objective as such, but we also know that the client will be sensitive to this issue. Our clients in fact expect a mix of capital preservation and outperformance of their benchmark. This is always the challenge – not to lose money – and in the meantime to outperform the benchmark.” (France)

There are differences among countries which need to be highlighted. While German wealth managers clearly prioritise capital preservation as their raison d’être, operators in the UK and Ireland typically tend to define their business in a more dynamic way (such as in terms of capital growth or maximisation of returns).

“Capital preservation is the priority for our private clients. They also expect a minimum return of 4–5%. Nevertheless we always have the issue of capital preservation versus return. Our clients are not satisfied if the German DAX is performing at 20% while we achieve a return of 5%, therefore we have to take market performance into account. However, in a bear market, capital preservation remains the main objective.” (Germany)
Asset Allocation Based Profiling Remains Mainstream

Client profiling remains at the core of DPM services. Most interviewed operators combine standard profiles and tailor-made approaches (restricted to large portfolios). Profiles are a translation of investors’ risk appetites and return expectations (over a given time horizon) into asset allocation boundaries.

“We define our service offerings as a matrix structure. On one side of the equation you have the risk awareness of the client and on the other side you define the expectation for revenues (e.g. income, stable growth). This matrix structure offers you a range of profiles.” (UK & Ireland)

Only three participants responded that they only offer customers a fully individualised approach. This typically includes access to a personalised selection of (non-standard) asset classes.

Across Europe, the average number of client profiles used by wealth managers is seven (excluding versions in the various currencies). Private banks operating in Italy and the Benelux region run the highest number of profiles (see Figure 5). The trend for most wealth managers is to rationalise the number of profiles in order to reach a higher degree of “industrialisation” of DPM services.

Figure 5: Number of Profiles Used (currency versions) - 53 respondents.

Client profiles are usually defined alongside a traditional scale of prudent/conservative to dynamic/aggressive. The difference between such profiles lies in the relative weight of “performance” asset classes in the asset allocation mix (e.g. equities and alternatives as opposed to fixed income or cash). Although there is no strict homogeneity of the definition of a conservative or a balanced profile among wealth managers, most use similar boundaries in their allocations to these asset classes. A balanced profile is thus typically defined as a “50-50” portfolio of fixed income and equities, even though the intra-bucket asset allocation can significantly diverge.

European HNW clients today are mostly allocated to balanced and conservative profiles (Figure 9), reflecting their focus on capital preservation. In Italy and Germany, the use of conservative profiles is clearly dominant, as would be expected from the objectives highlighted previously in Figure 4.

Figure 6: Most-Often Used Client Profile in the Different Regions/Countries

Main risk profile – Number of respondents

50% CLIENTS ARE IN BALANCED PROFILES
Asset Allocations are Anchored in Fixed Income

When analysing asset allocations at the DPM level, wealth managers typically differentiate between the “core” portfolio, the objective of which is to secure capital and provide some form of minimum return, and the “performance” portfolio. The former is primarily made of fixed income securities (and cash) while the latter has a more diversified profile (including equities and, potentially, alternatives).

Comparing DPM asset allocations across Europe, we focus on the most frequently used profiles by wealth managers. Given the prudent/conservative bias mentioned above, allocations are dominated by fixed income.

In order to highlight asset allocation differences among countries, we compare the structure of the most prudent portfolio used by wealth managers and look at the relative share of equities in Figure 7. It stands at an average of 21%, with negligible variations around this level between countries. What is worth noticing is the flexibility available to wealth managers. In Belgium, for instance, equities can vary from 0% to 40% in the overall allocation of the prudent portfolio. We will return to this notion of flexibility in the following section.

At many private banks in Europe, prudent portfolios are still fully invested in fixed income (see Figure 8). This is a reflection of the final investor’s traditional bias toward domestic government bonds, which are perceived as risk-free instruments.

Figure 7: Maximum Equity Allocation and Average in the Prudent Portfolio

At many private banks in Europe, prudent portfolios are still fully invested in fixed income (see Figure 8). This is a reflection of the final investor’s traditional bias toward domestic government bonds, which are perceived as risk-free instruments.

Figure 8: Average Asset Allocation Weighted by DPM Assets
(based on most frequently used profile only, 54 respondents)

“Our prudent portfolio still is 100% fixed income with major weights in corporate and government bonds. In addition we diversify with high yield and emerging markets bonds.” (Benelux)

Asset Allocations at Global Private Banks

Most global wealth managers have strived to rationalise and make their approach towards asset allocation more consistent in their DPM business. This usually takes the form of a top-down process whereby asset class views are expressed on a regular basis by the central investment office, driven by their macro analysis.

In turn, managers in the various investment centres are expected to implement these views across the portfolios they oversee. Exceptions apply, depending on:

- Local regulatory constraints (not all instruments/asset classes are available in all countries for retail clients)
- Local specificities and preferences in terms of allocations (e.g. use of life insurance in France, eurozone “peripheral” bias in Italy).

However, the leeway allowed to the local DPM offices has certainly been reduced over the past years.

“We remain partially independent from the house view and are thus free to buy what we want. Nevertheless we have to implement the global allocation committee recommendations, but with local adaptations. For example, our fixed income investment universe is the JPM EMU for the euro segment. Within this universe, Italy has a weight of 18-20%. But in our portfolio we might apply a more “domestic” point of view, so we can allocate a higher weight to peripheral countries.” (Italy)
Several structural factors have led wealth managers to reassess their approach in terms of investment management and asset allocations over the past five years. These include:

- The global financial crisis, now five years old, which represents a watershed for the wealth management industry in the way it shook the fundamentals of the business and led private banking operators to refocus on capital preservation.
- The eurozone government bond crisis three years ago, which led to the disappearance of the risk-free rate and put into question wealth managers’ traditional portfolio construction approach.
- The current financial environment, characterised by low interest rates, which undermines wealth managers’ ability to easily meet private clients’ investment objectives.

In this complex environment, the wealth manager model has had to adapt. Through the course of our interviews, we have identified three main areas of change:

- Client profiling
- Portfolio and risk management
- Client communication

We review each of these evolutions hereafter.

Management of Client Profile Offering

Most wealth managers have rejected redefining asset allocations in their client profiles.

“No new risk profiles have been created. But we have increased the flexibility of management of our profiles. We also change clients between profiles with greater ease as circumstances change. If no profile fits we use tailor-made strategies.” (Benelux)

However, the launch of new and innovative profiles is key in today’s markets. Underpinning this concern lies a quest for more asymmetrical risk profiles to protect client wealth on the downside.

Pushing Clients Towards Riskier Profiles

Wealth managers believe that they are facing a conundrum: most of their clients are naturally categorised in the prudent/conservative profiles, yet the latter no longer meet investors’ return expectations.

Instead of changing the definition of client profiles, most wealth managers have put in place active steps to migrate clients towards more dynamic profiles. Alternatively, it has become necessary for wealth managers to better manage investors’ return expectations. More than half of our panel respondents (32) are following this route.

“We try to educate our clients and explain to them that this kind of conservative portfolio is not the risk-free portfolio it has been during the past decades during the fixed income bull-run, and that they had better consider other, more adapted, profiles.” (UK & Ireland)

Discretionary Portfolio Management in a Low Interest Rate Era

82% of respondents confirmed increasing diversification in their DPM portfolios.

53% of wealth managers are migrating investors towards more dynamic client profiles.
Launch of Absolute Return Profiles

With this in mind, a number of wealth managers (17 in our panel) have pioneered the use of absolute return profiles and are currently encouraging their clients to migrate to it.

“We believe that absolute return strategies are one way to closely align the objectives of the asset manager with those of the client which, ultimately, are to preserve capital. That, they clearly understand.” (Switzerland)

Additional asymmetric strategies have been explored by wealth managers, using constant proportion portfolio insurance (CPPI) or structured products for example. They remain marginal as of today.

“We are trying to introduce new CPPI products with various possibilities: spread, volatility, etc. This is more a rule-based risk budget and here the maximum equity exposure is up to 20%. (Switzerland)
Increased Portfolio Management Flexibility

In the current environment, active asset management and increased flexibility are perceived as imperative by most wealth managers. This search for reactivity takes two main routes:

• Wealth managers are making maximum use of the flexibility allowed between asset allocation boundaries set for each client profile
• They increasingly use ETFs for tactical management purposes.

Active Management and Asset Allocation Techniques Currently Prevail

Buy-and-hold strategies, and waiting for monthly allocation meetings to adjust portfolios, seem to be restrictions of the past. Wealth managers have had to make maximum use of the flexibility allowed around the asset allocation targets.

“Before the crisis we already had the ability to deviate from the target weights. But the reality was that we did not need to. Sometimes we deviated by +/-2% and that was considered substantial. Now we are trying to make use of this flexibility as much as possible and more systematically. At the moment, we are underweight 15% on corporate credit, i.e. the maximum allowed.” (Switzerland)

Tactical Asset Management Means ETFs

Alongside the greater use of pooled funds, the share of ETFs in DPM portfolios is increasing. This is a reflection of the fact that ETFs are the vehicle of choice to implement tactical asset management in DPM, as well as passive investments. ETFs make up an average of 11% in total pooled fund assets (based on a sub-panel of 44 respondents).

Figure 9: ETF Investments as a Percentage of Investments in Pooled Funds

4% 6% 15% 29% 12% 11%
Benelux France Germany Italy Switzerland UK & Ire.

“Timing is of particular importance — being in the right place at the right time. Static asset allocations cannot weather all market conditions; a dynamic approach to asset allocation is key to avoiding considerable losses at times of market stress.”

Frédéric Dodard, Managing Director, Head of Portfolio Management, EMEA, State Street Global Advisors

“Of the total DPM AUM is invested in pooled funds of which is invested in ETFs (average)
Factor-Based Investing: The New Frontier for DPM?

Over the past few years, factor-based investing has gained wider traction among the investment community, though its roots can arguably be traced back to the 1970s. The 2008 crisis shone the spotlight back onto the limitations of portfolio diversification by asset class, as across-the-board correlation risk materialised.

Factor-based investing tries to mitigate the risk of a specific factor impacting multiple assets in any given portfolio and thus negating the benefits of asset class diversification.

However, only seven private banks (out of 60) implemented risk factor-based asset allocation or actively consider it as a new solution in structuring new client profiles.

“We need new ideas and we are implementing structures to define risk weights in the portfolios, alongside the share of equities. Risk factor-based assets allocations play an important role.” (Germany)

Most wealth managers tend to view factor-based asset allocation as too complex and computationally intensive. As a result, the strategy is not easy to explain to private clients and seems more appropriate for institutional investors.

“We started implementing risk factor-based asset allocations five years ago for our institutional clients, but there is no demand on the private client side. It is perhaps too abstract to explain considering our clients are traditional investors.” (Switzerland)

Changes to Portfolio Management Strategies

For all wealth managers, increasing diversification has been the name of the game over the past years. This is true for the core portfolio which, traditionally, was built around buy-and-hold positions in fixed income securities (primarily local government bonds), but also for the performance portfolio, as historical sources of returns have proved too volatile (equities) or have sometimes been disappointing (hedge funds).

This translates into increasingly granular investment portfolios today, as highlighted in Figure 10.

More than 80% of respondents confirmed increasing diversification in their DPM portfolios.

Increased diversification usually goes hand in hand with increased flexibility, and impacts both the type of instruments that discretionary portfolio managers invest in and the asset allocation techniques they rely on to optimise asset allocation.

Figure 10: Schematic View of Asset Allocations in DPM
Increased Diversification

The end of the long fixed income bull run has been expected for several years now and all wealth managers interviewed are aware of risks related to the current interest rate environment. This means that an asset class which has traditionally been considered as safe, and widely used in the prudent/conservative profile, may lead to losses in client portfolios should interest rates rise again. In addition, the eurozone crisis in 2011 has highlighted the fact that instruments that were traditionally considered as risk-free (sovereign bonds) may not actually be that safe.

The Risk-Free Rate Has Vanished

For most wealth managers, there is no longer such a thing as a risk-free rate. While government bonds used to be considered the easy way to build a portfolio and adjust allocations to the investor’s return expectations and risk tolerance, this is no longer possible.

This perception is shared by most wealth managers across Europe, with some notable differences: whereas government bonds have lost their status, money market/cash is widely viewed as the new risk-free rate. This is challenged by many respondents as, even though it might not be in negative territory yet, short-term returns today are below inflation and therefore carry a risk for the investor whose objective it is to secure a minimum return. If the latter is mere capital preservation in absolute terms, then the use of cash makes sense, as long as holding cash does not cost (which is becoming the case at some banks in the eurozone).

In France, the guaranteed life insurance contract is sometimes used as the risk-free benchmark to be outperformed by wealth managers.

Changes to the “Minimum Return” Portfolio

A relatively immediate adjustment would be to decrease fixed income exposure to the benefit of other asset classes. Although theoretically possible, few wealth managers have actually considered this strategy:

- The other available asset classes were not necessarily perceived as more attractive
- This approach would impact their client profiling scale.

“Wealth managers are thus constrained to keep using a majority share of fixed income instruments in their prudent portfolio. In order to manage the risk of a potential interest rate hike and subsequent capital loss, they resort to a higher degree of diversification, more flexible management and the use of short duration products (see Figure 12).”

Figure 11: Perception of the Risk-Free Rate in the Different Countries

![Figure 11: Perception of the Risk-Free Rate in the Different Countries](image)

Figure 12: Managing Interest Rate Risk In the “Minimum Return” Portfolio

![Figure 12: Managing Interest Rate Risk In the “Minimum Return” Portfolio](image)
Diversification within the fixed income bucket can be summarised as diversification across geographical areas (US credit, emerging debt, etc.) and the increased use of various sub-asset classes (corporate, covered, high yield, etc.)

“Five years ago, our prudent portfolio was invested in high grade sovereign bonds for up to 80 or 90% of the fixed income allocation. The rest would be in corporate bonds. Today, the scene has changed completely. We almost no longer use sovereign bonds. Prudent portfolios are made of corporate bonds and senior loans. Sometimes we use emerging debt. That is how we manage sovereign default risk. Interest rate risk is managed by lowering the duration on the portfolio.” (Switzerland)

Another key evolution is the higher flexibility that wealth managers can take advantage of within their fixed income bucket in terms of duration and asset allocation to sub-asset classes.

“Today, given the abnormally low interest rates, you cannot afford not to be active in asset management. We thus actively manage duration. Buy-and-hold is over.” (France)

Changes to the Performance Portfolio: Increased Use of Alternative Asset Classes

The profile of the performance portfolio is also changing. While equities remain the main asset class used for generating long-term returns, wealth managers increasingly use other sources of performance. Most-often used alternative asset classes include:

• Real estate
• Private equity
• Alternative funds

The status of each asset class differs considerably between the countries. In the UK and Ireland, the use of real estate is widespread. It is not the case in France or Italy.

The use of alternative funds is also well established in a number of countries. However the format differs. In France, wealth managers only invest in Newcits. In Switzerland, portfolios are more diverse and include funds of hedge funds or segregated products specifically designed for the private bank.

There remain significant obstacles for the inclusion of alternative products in DPM. One major constraint is organisational, as DPM desks seldom have the possibility to deal in illiquid products. The latter are only made available in the advisory business line.

“Real estate and private equity are excluded from our investment universe. The reason is simple: there would not be enough liquidity within these products.” (Germany)

“We want to make sure we restrain ourselves to liquid investments. We give our clients a one-day liquidity notice and are thus restricted to invest in +1 or +3 liquid products. Although we are not actively moving portfolios we tend to stay flexible and rebalance our positions in order to reduce the risk of loss due to liquidity risk.” (UK & Ireland)

Figure 13: Use of Diversifying Asset Classes in the Performance Portfolio

<table>
<thead>
<tr>
<th>Number of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate</td>
</tr>
<tr>
<td>Benelux</td>
</tr>
<tr>
<td>6</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>France</td>
</tr>
<tr>
<td>2</td>
</tr>
<tr>
<td>2</td>
</tr>
<tr>
<td>7</td>
</tr>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>5</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>Italy</td>
</tr>
<tr>
<td>2</td>
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<tr>
<td>2</td>
</tr>
<tr>
<td>3</td>
</tr>
<tr>
<td>Switzerland</td>
</tr>
<tr>
<td>5</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>UK &amp; Ireland</td>
</tr>
<tr>
<td>9</td>
</tr>
<tr>
<td>7</td>
</tr>
<tr>
<td>7</td>
</tr>
</tbody>
</table>

c.60% OF RESPONDENTS INVEST IN AN ALTERNATIVE ASSET CLASS

Ana Harris, Portfolio Strategist, Global Equity Beta Solutions, State Street Global Advisors

“The hunt for yield and new approaches to lower volatility equity portfolios is driving interest in advanced beta products. The huge surge of UCITS ETFs, once the preserve of institutional investors, is testament to this.”

State Street Global Advisors 17
The Controversial Use of Multi-Asset Funds

The use of multi-asset funds in DPM is not widespread. In our panel, only 38% of wealth managers are investing in such products with a view to benefit from the embedded active management and diversification that these vehicles are meant to provide.

“We are happy to integrate multi-asset funds into our absolute return portfolios if we are in a position to follow and understand what the manager is doing. What we want to avoid at all costs is the risk of double bets.” (Switzerland)

The majority of respondents still stay away from multi-asset funds. The main reason cited is the lack of transparency and control over what is happening in the fund, which translates into a loss of power over the asset allocation process and increased concentration risk (“double bets”).

“Multi-asset funds are not used in wealth management mandates. We don’t want their inherent allocation and diversification to influence our own portfolio allocation.” (Benelux)

Risk management concerns also prevent wealth managers from investing in these vehicles.

“We do not invest in multi-asset funds, because within our risk management framework the allocation into pure asset classes is very important, and our risk system cannot evaluate a multi-asset fund. It might make sense to offer this kind of different correlation strategy in a discretionary management portfolio, but the risk management could not implement this.” (Switzerland)

Figure 14: 23 out of 60 Wealth Managers Interviewed Use Multi-Asset Funds

<table>
<thead>
<tr>
<th>Region</th>
<th>Number of Wealth Managers Using Multi-Asset Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benelux</td>
<td>4</td>
</tr>
<tr>
<td>France</td>
<td>3</td>
</tr>
<tr>
<td>Germany</td>
<td>5</td>
</tr>
<tr>
<td>Italy</td>
<td>4</td>
</tr>
<tr>
<td>Switzerland</td>
<td>3</td>
</tr>
<tr>
<td>UK &amp; Ireland</td>
<td>4</td>
</tr>
</tbody>
</table>
Smart Beta Products
Smart beta products (as pooled funds) are increasingly used by wealth managers as part of their diversification strategy.

“Smart beta and minimum volatility products are new products we have already worked with. But only if they fit with the overall philosophy. It is certainly something we looked at and keep looking at, although I don’t know if it will increase.” (UK & Ireland)

“I do not think that risk factor-based asset allocation is the magic bullet. Of course it can be of interest, but we don’t have the tools to implement it directly because it requires a lot of reactivity. Turnover is higher and we cannot spend our time shifting the allocations of a prudent portfolio, for example. There is a collective funds offering which provides a risk factor-based asset allocation that is perfect for us to use in discretionary management.” (France)

Increased Use of Funds
A final trend worth highlighting is the increased use of pooled funds in DPM. The traditional model for wealth managers is to invest in securities (bonds and equities) on a direct basis and in funds for diversification only. As the scope of diversification has significantly expanded over the past few years, so too has the use of funds. They are viewed as an additional tool to enhance diversification in each underlying asset class, as allocated amounts often appear sub-scale to ensure sufficient diversification.

In addition, wealth managers increasingly seek to benefit from external expertise provided by pooled funds.

At the European scale, investments in funds represent almost half of total assets under management for wealth managers in the DPM business line. Germany appears as a statistical “outlier” in this analysis, as direct investments in securities are still preferred by wealth managers (see Figure 15).

“We almost never use securities except for core portfolio fixed income buy-and-hold positions or when we receive legacy stocks in a client’s portfolio. The systematic use of mutual funds is one way for us to improve portfolio diversification and risk management.” (Switzerland)

47% OF WEALTH MANAGERS ARE INVESTING IN POOLED FUNDS

Figure 15: DPM Investments in Pooled Funds
Increased Focus on Risk Management

The last trend which should be highlighted is the increased focus of wealth managers on risk management. Here again, the lessons of the financial crisis have been learned and corrective actions taken by operators.

Risk Management Has Gained in Importance

All respondents agree that risk management has gained in importance since the pre-crisis period. Most wealth managers have strengthened their exposure limits and concentration risk monitoring.

“We have always had an eye on active risk management. What has increased in importance for us after the financial crisis is monitoring concentration risks. We are monitoring the concentration of asset class weights and geographical areas, and we try to keep it well diversified. We are also continuously seeking new processes and innovations in products.” (UK & Ireland)

More Widespread Use of Quantitative Indicators

Volatility and Value at Risk (VaR) measures are almost systematically used by respondents.

“We only use volatility as a limitation; the different risk profiles are based on volatility boundaries and provide our clients with a new structure of funds to control the risk in their portfolio. This is a completely new approach, which is in high demand.” (UK & Ireland)

The absolute loss limit, better defined as the maximum drawdown, is emerging as an increasingly widespread indicator in DPM. One of its advantages for client relationship managers is that investors naturally grasp its meaning.

“Our first limit is the maximum drawdown that we have assessed with the client, while internally we have our stress testing parameters such as VaR, volatility etc., that we put through the system. However, they are not communicated to the client as they do not understand them. We only express what proportion of money they could lose, very simply and in concrete language. The exceptions are family offices or small institutions, who can understand more technical terms as they have their own financial advisors.” (Italy)

Liquidity Risk and Stress Tests

Finally, stress tests are more systematically implemented to measure liquidity risk at portfolio level, in spite of their inherent limitations.

“In terms of risk, we are closely watching the liquidity of our assets. We run stress tests to observe the liquidity risk in our portfolio. We are only focusing on liquid products and this has protected us from several crises.” (Belgium)
Client Communication: The Ultimate Challenge for Wealth Managers

In an era of increased transparency and widespread access to financial information through the media, communicating performance and risk remains a challenge for most wealth managers.

In this area, operators are also led to innovate. Leveraging online tools and strengthening interaction and proximity with investors are critical.

Communicating Performance: Bridging the Gap Between Clients’ Expectations and the Investment Process

Communicating performance is the first and foremost point of connection between the wealth manager and their client. Despite investors’ central objective of capital preservation, most wealth managers still communicate portfolio performance in relative terms versus:

• A (composite) benchmark, or
• Peer group performance.

This is also a reflection of regulatory constraints that wealth managers are facing in some of the countries.

“We communicate the results/performance to clients against benchmarks. But we use the benchmark more as a monitor of what happened in the capital markets rather than against our performance. We emphasise the preservation of capital and the risk-adjusted yield as they are more important for our clients.”

(Germany)

33% of wealth managers communicate performance versus multi-asset funds or a specific peer group benchmark, such as the ARC (Asset Risk Consultants) Index.
Meeting Clients’ Demand for Increased Transparency and Higher Frequency of Communication

Managing the gap between expected return and achievable return (in a given risk profile) remains the main issue today in terms of client communication. As a result, this task is becoming more time and resource-consuming for wealth managers.

“Financial markets are more and more complicated and volatile. Clients are allergic to mathematical terms but they have understood the impact of volatility and different market events, even the potential for losing money in bonds like 1994. But newly wealthy clients do not know what happened before. So we spend a lot of time describing the portfolio composition, and the risks to people who are not in the financial sector.” (Italy)

In addition, wealth managers have to meet clients’ expectations for increased transparency and more regular contact.

“Most clients consider fixed income to be something that pays 4–5% a year risk-free. We therefore need to make them accept more volatility in their portfolios which is very difficult. But we see that they are now more interested and want to participate in these discussions.” (Italy)

This is leading wealth managers to innovate in the way they manage client relationships. Two types of initiatives are worth highlighting:

• The increased use of online channels to disseminate information to clients on the macroeconomic environment and related adjustments to portfolio management
• The introduction of “investment specialists”, sitting halfway between portfolio managers and client relationship managers, whose role is to improve communication with clients on performance and risk.

“Communication with clients is quite challenging and has changed a lot in recent times. Today, clients are much more interested in detail and how we manage and decide. We have established a new client communication team with portfolio managers who are capable of meeting end-investors’ information demands.” (Germany)

“We communicate a macroeconomic review of asset classes and for our funds in a newsletter. The information is also on a blog and on social networks (e.g. LinkedIn). Everything is online. The minimum client communication requirement is monthly reporting, so that the client can access the portfolio on a daily basis.” (Benelux)

The investment specialist role is ever-more critical today as wealth managers strive to promote more complex client profiles. End-investor education has become a key factor for success in the DPM business.

“We place emphasis on client education in the first year as the client can be anxious. During the second year they start to understand our reporting and the regular communication we provide, and in the third year we are confident that client fully understands our management.” (France)

“The financial advisory business is changing and becoming more and more transparent. The wealth management model too has transitioned from product to a service. As with selecting other service providers, such as a family doctor, the advisor that the client chooses is frequently the one they feel that they can trust the most.”

Rory Tobin, Executive Vice President, Head of European Distribution, State Street Global Advisors
The New Asset Allocation Paradigm

CONCLUSION

Over the past five years, the wealth management business has undoubtedly become more complex and challenging. Not only has the industry had to deal with the repercussions of the global financial crisis, which jeopardised the traditional private banking business model, but it has now had to adapt to low interest rate conditions.

This report has tried to shed some light on how wealth managers across Europe are striving to adapt to this changing market environment and put their clients back at the centre of their business after years of restructuring.

- The fundamentals have not changed: capital preservation remains the core objective; and end-investors are still allocated to asset allocation type of profiles, the definition and overall asset mix (bonds versus equities) of which has not changed.
- Yet, wealth managers have had to change the way they manage portfolios and define asset allocations. These evolutions include increased diversification (both in the core and performance sections of the allocation), increased asset management flexibility and increase use of ETFs and pooled funds.
- In addition, with the introduction of new profiles (such as absolute return profile) and proactive management of client categorisation, it has become necessary to better manage end-investor expectations.
- Finally, these evolutions require significant investments on the risk management front. Strengthening processes and systems has been a relentless preoccupation for European wealth managers.
- Improving client communication remains the “holy grail” for wealth managers. In this area, they are also led to innovate, making full use of online tools and putting in place dedicated teams of investment specialists.
THESE EVOLUTIONS ARE A TESTAMENT TO HOW WEALTH MANAGERS ARE ADVANCING THEIR STRATEGIC OBJECTIVES TO BETTER ALIGN THEIR BUSINESS MODELS WITH THEIR CLIENTS’ INTERESTS.
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