momentum

viewpoint

June 2012

global investment management

The sharp selloff in markets in May continued into the early days of June, with the market's attention firmly focussed on the debt problems in the Eurozone and growing evidence of a slowdown in the key economies of the US and China.

Spain finally succumbed to an inevitable bailout request at the start of the month, asking the Eurozone for EUR 100 billion of funding to support its ailing banking system. While the acceptance of the need for help and the Eurozone's agreement to assist initially calmed markets, investors took fright when the terms of the support left many questions unanswered. In particular, it appeared that the bailout funds would be lent to the Spanish government and not directly to banks, thereby adding to the burgeoning public debt burden, and that existing bond holders would be subordinated. Spanish bond yields duly rose to over 7%, considered to be an unsustainable level.

Sentiment began to improve, however, ahead of the Greek elections on 17 June, as fears over a socialist party (Syriza) victory began to recede. The socialists campaigned on a platform of rejecting the terms of Greece's bailout from fellow Eurozone members, raising the real risk of a disorderly exit from the euro and a full debt default. A gradual shift in opinion polls and heavy Greek support for staying as part of the single currency began to improve investor sentiment. This was then justified with the centre right party winning enough electoral support to be able to form a coalition government and thereby avoid the immediate risk of disorderly exit and default.

Equity markets began to recover some poise, while still remaining very uncertain, especially over the unfolding events in Europe and notably Spain. Government bond yields in peripheral Europe began to stabilise and investors returned cautiously to equities. Noises from key central banks in Europe and the US also suggested that the authorities were ready to resort to further monetary easing, in a bid to add liquidity to the system.

With European leaders meeting at the end of June for the 19th summit since the Eurozone debt crisis erupted, investors held out little hope of any substantive progress towards the type of structural reforms required to engineer a sustainable long term solution to the region's problems. In the event, Germany offered a surprise, by agreeing to some modest growth initiatives and much more importantly to direct bailouts of Eurozone banks from European funds in return for more centralised supervision of the sector. Agreement was also reached that loans to indebted Eurozone countries from central coffers would not be senior to existing debt, thereby maintaining the status of all bond holders.

The result was an immediate rally in equity markets as sentiment improved dramatically amid hopes that Europe was gradually moving towards greater integration and an enhanced fiscal union. The MSCI World index rose by 3% in a single day, its biggest move of the year, and many European markets rose by over 5%. Yields on peripheral European debt markets fell sharply. The net result was that the MSCI World index gained 5.1% over the month, with Japan leading the way with a 7.2% rise. Safe haven government bonds including US treasuries, UK gilts and German bunds alternatively lost ground. Despite this performance from the rates market, spread compression helped investment grade and high yield

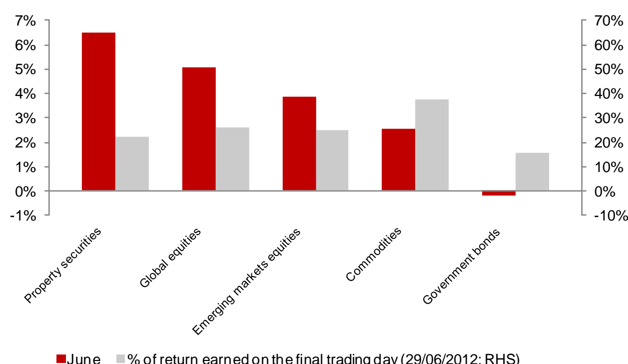
Source: Bloomberg/ Lipper Hindsight. June 2012.

fixed income to gains, whilst emerging markets bonds were also the beneficiaries of investor flows.

Commodity markets did not participate fully in the recovery as investors remained concerned that the apparent slowdown in global growth, especially in the Chinese economy which has been the biggest buyer of commodities in recent years, would spell an end to the commodities super cycle. Despite a recovery at the end of the month the oil price was still down by 11.5% in June, taking its cumulative fall to over 30% since the peak earlier this year, while industrial commodities were flat. Gold rallied but by less than equities, with a rise of 2.6%.

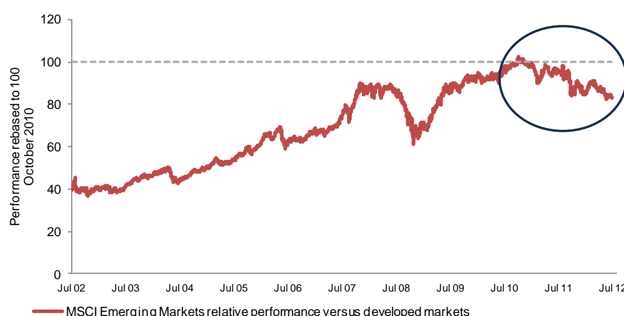
Figure 1 summarises the returns of major asset classes last month, and the proportion of gains that were earned during this final day's trading.

Figure 1: Total returns by asset class (US dollar terms)



Stocks in emerging markets (EM) underperformed their developed counterparts in June, with the MSCI EM aggregate rallying by 3.9% in US dollar terms. This underperformance is consistent with the trend established since October 2010. Figure 2 highlights the relative performance of EM equities over the past 10 years, rebased to 100 at the end of October 2010.

Figure 2: EM underperformance since October 2010



measures, including price-to-book and price-to-sales, relative to the preceding five years of data.

The markets are now at an interesting juncture. On the one hand the Eurozone crisis has eased a little, and there are steps underway towards closer Eurozone integration in monetary and fiscal matters. Whilst we are still clearly a long way off a full fiscal union and issuance of Eurozone backed bonds, at least some of these issues are now on the agenda. There is a long way to go before the debt crisis in Europe is resolved but the euro endures and there has been no disorderly exit or default. Monetary policy remains extremely loose, with the European Central Bank cutting rates by 0.25% post the end of the quarter, whilst the Bank of England has embarked on another round of quantitative easing and the Federal Reserve has extended Operation Twist and will provide more support as and when needed. The fall in commodity prices, especially oil, will see inflation falling and will provide a welcome bonus to consumers.

Yet on the other hand economies have slowed and there is little to suggest that they will bounce back to higher growth levels in the near future. China is slowing structurally, and moving to a less commodity intensive economy, large parts of Europe are in recession and will remain so as fiscal austerity bites and the US faces its own fiscal consolidation post November's Presidential election. Companies remain cautious in this environment and recent earnings announcements have reflected much slower growth, whilst the debt overhang globally will keep risks high and spending subdued for many years to come.

These competing forces are likely to result in continuing volatility in markets in the months ahead, with periods of decent growth punctured by periodic setbacks. Underpinning equity markets, however, are pockets of value. Historically, starting valuations have been a powerful determinant of future equity returns, and, whilst wary of the macroeconomic environment, today's stock market levels warrant a closer inspection by investors.

Source: Bloomberg/ Lipper Hindsight. June 2012.

		To 29 June 2012		
Asset class/region	Index	Currency	Month	Year to date
Developed markets equities				
United States	S&P 500 NR	USD	4.1%	9.1%
United Kingdom	FTSE All Share TR	GBP	4.8%	3.3%
Continental Europe	MSCI Europe ex UK NR	EUR	5.6%	4.2%
Japan	Topix TR	JPY	7.2%	7.0%
Asia Pacific (ex Japan)	MSCI Pacific ex Japan TR	USD	6.3%	5.9%
Global	MSCI World NR	USD	5.1%	5.9%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	11.9%	6.6%
Emerging Asia	MSCI EM Asia NR	USD	2.5%	5.0%
Emerging Latin America	MSCI EM Latin America NR	USD	3.9%	-0.5%
BRICs	MSCI BRIC NR	USD	3.5%	0.4%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	3.9%	3.9%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	-0.4%	1.7%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	-0.6%	4.2%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	0.4%	4.7%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	2.1%	7.2%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-1.0%	1.8%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	0.3%	5.0%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	-0.7%	3.7%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	-0.2%	5.7%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	1.9%	11.6%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	-0.1%	1.4%
Australian Government	JP Morgan Australia GBI TR	AUD	-0.6%	5.3%
Global Government Bonds	JP Morgan Global GBI	USD	-0.2%	0.4%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	0.4%	1.3%
Global Convertible Bonds	UBS Global Convertible Bond	USD	2.4%	5.0%
Emerging Market Bonds	JP Morgan EMBI+	USD	3.8%	6.9%

Source: Lipper Hindsight. June 2012.

Asset class/region	Index	Currency	Month	Year to date
		To 29 June 2012		
Property				
US Property Securities	MSCI US REIT NR	USD	5.5%	14.3%
UK Property Securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	4.9%	14.2%
Europe ex UK Property Securities	FTSE EPRA/NAREIT Developed Europe ex UK TR	EUR	3.9%	10.7%
Australian Property Securities	FTSE EPRA/NAREIT Australia TR	AUD	4.2%	16.6%
Asia Property Securities	FTSE EPRA/NAREIT Developed Asia TR	USD	8.4%	18.2%
Global Property Securities	FTSE EPRA/NAREIT Developed TR	USD	6.5%	15.3%
Currencies				
Euro		USD	2.6%	-2.2%
UK Pound Sterling		USD	1.9%	0.9%
Japanese Yen		USD	-1.7%	-3.6%
Australian Dollar		USD	5.7%	0.0%
South African Rand		USD	4.7%	-1.3%
Commodities & Alternatives				
Commodities	RICI TR	USD	2.5%	-5.2%
Agricultural Commodities	RICI Agriculture TR	USD	8.7%	-0.2%
Oil	ICE Crude Oil CR	USD	-11.5%	-14.0%
Gold	Gold Index	USD	2.6%	4.4%
Hedge funds	HFRX Global Hedge Fund	USD	-0.3%	1.2%
Interest rates			**Current rate**	**Change at meeting**
United States	20 June 2012	USD	0.25%	-
United Kingdom	5 July 2012	GBP	0.50%	-
Eurozone	5 July 2012	EUR	0.75%	-0.25%
Japan	14 June 2012	JPY	0.10%	-
Australia	3 July 2012	AUD	3.50%	-
South Africa	24 May 2012	ZAR	5.50%	-

[e] Estimate

Source: Lipper Hindsight. June 2012.

Focus: Establishing key investment partnerships to enhance the Wealth Management business model

Executive summary

With the fundamental changes taking place in the wealth management industry, many Wealth Managers and Advisers are being forced to review their business models and make significant structural changes. The Retail Distribution Review ('RDR') has fundamentally changed the landscape and in the coming months will reshape the players in the market and how they work with their clients. Whilst a UK problem for now, Wealth Managers in other jurisdictions should consider whether this legislation is a vanguard of similar changes to come into effect elsewhere around the world.

This paper summarises some of the changes that are already happening and offers a view of what may be on the horizon.

The key findings include:

- Wealth Managers and Advisers will need to undertake a full review of their proposition to ensure they can implement a 'treating customers fairly' ('TCF') policy and provide value-added, cost effective advice
- The change from trail to a fee-based model has huge ramifications on the client proposition going forward: managing this will be crucial for businesses to be successful
- Strategic partnerships can enable Wealth Managers and Advisers to offer a competitive edge while maintaining their focus on clients
- Mergers and acquisitions will be widespread as firms look to manage costs and increase efficiency
- Doing nothing and hoping RDR will go away is not an option

Introduction

It could be argued that we are on the cusp of a golden era for wealth management: with increased life expectancy and investment complexity, a challenging environment for investing and an irreversible shift in pension arrangements from defined benefit to defined contribution, the value of financial planning – and hence the importance of the wealth management industry – is set to come to the fore. At the same time, the regulatory landscape is undergoing a once in a generation change and the likely consequences for the industry, while still evolving, will be far reaching. Whichever route the Wealth Manager (WM) takes – independent or restricted – it will require extensive planning and preparation.

Whatever the ultimate shape of the industry, it is likely to become ever more competitive, and WMs who are able to create a strong, stable and clearly differentiated business will prosper in the long term. In an era of increasing competition and fee transparency, with probable compression of margins, designing a wealth management firm to exploit the coming uncertainties and changes will optimise the opportunities, drive the business forward and, ultimately, maximise its value. To do this we believe that WMs must be prepared to specialise and focus their time and effort on core skills and competencies. This means a clear and unwavering focus on financial planning: actively managing their clients' financial affairs through the various and changing needs demanded by their lifecycle.

It must be recognised that other services and advice provided to clients, such as legal, tax and accounting, are ancillary to this core service, which is ultimately the driving force of any successful wealth management business. In recognition of this need for focus and specialisation, WMs have typically outsourced non-core services. In light of the increasing complexity of investments and the need for focused, dedicated resources to be able to compete, the range of strategic partners will increasingly encompass the investment process, as WMs make use of independent, specialist investment research and portfolio management. Taking advantage of the services of specialist external investment partners, including the formation of strategic alliances, can assist successful WMs to further enhance their proposition.

What do wealth management clients want?

The most important requirement for most wealth management clients is to be provided with quality financial planning advice. This is the key specialisation of the wealth management industry and will generally include advice on the range of investments available and their suitability in light of a client's risk tolerance and preferred time horizon. Alongside this primary duty come other requirements, mostly service related. It is those WMs who maintain a sharp focus on these 'softer' services that best serve their clients. For example, most wealth management clients seek a personalised service, with direct access to the expert that provided them with the financial planning advice. As a result, WMs must be available for their clients and understand in detail their personal circumstances. Clients also expect flexibility and understanding relating to their changing needs, quick responses, impeccable administration, high ethical standards and, especially in a post RDR world, a fair, transparent fee.

In addition to this core function, WMs are often used as the hub for the provision of ancillary services such as legal advice, accounting services, tax and other ad hoc requirements. In such instances the WM will generally source a third party to provide the service rather than offer it themselves, especially if it is complex or of a highly specialised nature.

Challenges faced by wealth management firms

Wealth management firms face a multitude of challenges. Whilst the need to provide first class, impartial financial advice is ever present, changes to the industry environment – in particular those arising from dramatic shifts in the investment landscape over the past decade and those induced by new regulation such as RDR – will test the ability of WMs to adapt. The need for innovation and differentiation from the competition is arguably more important than ever. To maximise its potential, a wealth management business must ensure that its core offering is exceptional and yet also be able to offer competitive and credible services in all areas of its business. In areas where WMs lack the relevant expertise, the prudent choice is to use a specialist strategic partner. Numerous issues, risks and pitfalls can, to a greater or lesser extent, be mitigated by the use of select outsource providers:

- Regulation
- Increased competition
- Mission creep: large investment firms moving into wealth management
- DIY and disintermediation: individuals investing directly
- Margin compression
- Succession planning and continuity
- Differentiation in a crowded market
- Scale: offsetting resource limitations and cost pressures
- Consistency of advice plus quality and compliance controls across all advisers

What are most Wealth Managers good at?

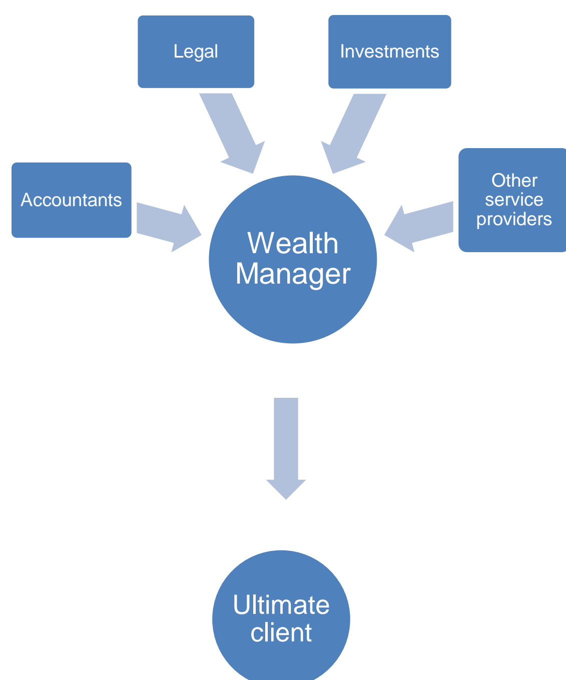
Successful WMs fulfil their clients' needs with respect to financial planning, service levels and other such core requirements. The majority of successful WMs are also efficient as practice managers in that they do not overstretch themselves by attempting to provide services which are outside their sphere of competence. Indeed, it is apparent that the vast majority of successful WMs are willing to use third party specialists where they do not believe that they have the necessary expertise in-house and wish to reduce the risks and complexity of their business.

Historically WMs have been reluctant to outsource investment management as this has been viewed as central to their client proposition. This notion is now being challenged: in an increasingly competitive world the WM needs to determine and then focus on their core capabilities and areas of expertise or risk losing their edge in those key competencies. When the questions, *'What are my core competencies?'* and *'Where do I need to focus my efforts?'* are asked, financial planning will always appear at the top of the list. Which services, then, can more effectively be provided by other experts and specialists? The focus must be on building efficient, cost effective solutions where best of breed (use of specialist, external investment managers) is readily accessible.

This is an area where market leading investment partners can aid WMs significantly. The investment world has changed dramatically over the past decade. There has been huge growth in accessible investment instruments, notably passive products such as ETFs and retail alternatives previously unavailable or only available to the largest institutional investors. There has been a shift from 'products' to 'solutions and outcomes' based investing, identifying the goals that are most important to clients (for example, desired levels of income, target levels of risk) and then building solutions that closely match those needs. In turn those solutions use a diversified range of asset classes, available to retail investors through an ever expanding suite of instruments. The paradox of too much choice can then lead to use of closely matching products irrespective of client needs, simply to avoid the fear of being different or of failure.

Even without the advent of new regulation, these far reaching changes to the investment landscape and the risks they pose to the WM business point to the need for specialist skills aligned to a clear and replicable process. Given these considerations it seems probable that the investment function will increasingly be outsourced, if not in totality then to a large degree. Strategic partnerships and alliances are expected to come into their own in this sense, allowing the WM to still control the process while utilising specialist external capabilities.

Increasingly, WMs are likely to use select investment managers as specialist service providers, thereby enhancing the quality and credibility of their investment proposition, strengthening their business by reducing risk and controlling costs, and fulfilling their regulatory requirements. This leaves the WM free to concentrate on their core service offering to the ultimate benefit of the client base and hence the business itself.



The wealth manager forms the hub through which different professional service providers are routed. This serves to enhance the position of the WM as a provider of service excellence, whilst they retain their position as a gatekeeper to the client for other professional service providers.

Successful WMs need to recognise their competitive advantages and be prepared to take dispassionate decisions on outsourcing where the appropriate depth of skill is not available in-house. In the same way that specialist tax, accountancy and legal advice is sourced externally, investments will increasingly be provided by external specialists.

Key questions for the WM when considering the outsourcing of the investment function are:

- Can I hope to do an equivalent amount of research and be as well trained as a dedicated team at a specialist external investment partner?
- Can I offer access to 'whole of market'?
- Is carrying out the function in-house a scalable and profitable extension to my business or a costly distraction from my core competencies?
- Should I be spending valuable profits on internal resourcing to attempt to replicate the in-depth work undertaken already by potential strategic business partners?
- Can I instead piggyback on the work already carried out by a business partner?
- Why not be the access conduit to strategic partners thus cementing my position with my clients, leading to longer lasting client relationships?

The answers to these questions will generally lead to a decision to outsource. The question then arises as to the nature and extent of the outsourcing:

- Do I want to hand over full discretionary fund management and thereby run the risk of losing my client to the Discretionary Fund Manager ('DFM')? Do I want to retain some investment functions in house?
    - *Or* does that simply confuse the investment offering and blur lines of responsibility?
        - *Or* do I want to build a partnership arrangement enabling me to have a bespoke investment solution and retain control over my clients while making use of high quality specialist skills?

How can Wealth Managers 'future proof' their business model?

A key aim for any business that wishes to manage growth and stand the test of time is to make decisions based on a long term, sustainable business model. As a WM therefore, it is imperative to be flexible and focused with respect to clients' needs as well as your own business needs. As daunting as RDR and other developments may appear for many WMs, regulation is here to stay – the only certainty is that it will change through time and needs to be managed appropriately. An ongoing competitive edge enabling WMs to stand out from the crowd is key to future proofing their business.

Strategic partnerships, offering flexible and responsive services can help to ensure that WMs offer the best advice and service levels to clients. WMs must become innovators and leaders in their own area of expertise and make use of strategic partners with similar ambitions. In order to be flexible and future proof the business, it will be important to make use of structures, solutions and partners that can move swiftly to respond to changes in the regulatory environment, whilst also actively responding to client needs. At the same time centralised investment propositions are expected to grow in popularity, given their ability to provide consistency across a WM's client base, full compliance with the latest regulation and appropriate management of scale and hence cost. We are seeing a resurgence of multi-manager or fund of funds solutions, in recognition of the powerful case for best of breed and access to the whole of the market for investment products.

What should wealth managers look for in selecting investment partners?

In addition to the usual due diligence when selecting any investment product or solution (the 3 'P's of people, process and performance, plus the 'E' of evidence), the wealth manager has a number of vital additional considerations when selecting the outsource partner.

- How much control would I be prepared or would be required to cede?
- Is the intermediary market core to the investment firm and does the firm fully understand the needs of that market?
- Is the investment firm properly resourced to service the WM?
- How will the partnership add value to the WM / client relationship without compromising the ownership of that relationship?
- Will the partnership help the WM retain independent status?
- Does the investment manager offer help in matching portfolios to client risk profiles and how flexible is the firm in building solutions to match the specific needs of the WM's client base?
- What access is there to fund managers and will the WM have full transparency?
- What interaction will the investment firm have with the clients?
- What level of discretion do individual managers have?
- How will the WM be able to access the solutions?
- Does the partnership simplify or add complexity to the WM's business?

These issues call critically for genuine independence and flexibility in the investment partner, a readiness to respond to the specific needs of the WM, access to decision makers and communication on a regular basis through whatever channel is required by the WM. A solutions focus and ability to build genuinely bespoke services will ultimately be critical in enabling the WM to provide true differentiation and meet the exact needs of their client base.

Conclusion

The dramatic upheaval in the investment landscape over the past decade and the associated regulatory changes, including RDR, are leading to a wholesale review of the wealth management business model. We believe that a critical part of this will be to re-examine the investment process of WMs. This in turn may lead to substantially greater outsourcing of all or part of the investment process to specialist firms. It will increasingly be recognised that to stay at the forefront of the industry, the WM will need collaborative partnerships rather than ceding control completely over the investment process. A focus on client needs will necessitate bespoke solutions designed to deliver specific outcomes, with the flexibility to adapt to the changing demands of the client base and the market environment. Critically the partnership must be able to strengthen client relationships, lead to innovation and industry leading standards in the investment offering and its delivery, and ultimately create value for the underlying clients as well as the WM. A successful partnership will result in a substantially stronger franchise for the WM and continuing success and independence.

In conclusion, this calls for the selection of a flexible, solutions focused and independent investment partner, whose key attributes include a proven and replicable investment process, encompassing market leading investment research, asset allocation and portfolio construction.

James Klempster, CFA, Multi Asset Portfolio Manager

Manager meetings

	Long Only		
Manager	Asset Class	Date	Location
Mondrian	GEM	01-Jun-12	London
SSgA	Global Aggregate	06-Jun-12	London
Gemini	Global Bonds	06-Jun-12	London
Lindsell Train	Global / UK	07-Jun-12	London
Pioneer	Fixed Income	07-Jun-12	London
RWC	Convertibles	07-Jun-12	London
Pioneer	Fixed Income	08-Jun-12	London
Marvin and Palmer	Global / GEM	11-Jun-12	London
Schroders/Investec/JPM AM	Fixed Income	11-Jun-12	London
ING	Loans	12-Jun-12	London
THSP	Global / Europe	12-Jun-12	London
Tradewinds	GEM	12-Jun-12	London (Conf Call)
Franklin	Global	12-Jun-12	London
Fidelity	Strategic Bonds	13-Jun-12	London
Vulcan	Global / US Small Cap	13-Jun-12	London
Metropolis	Global	13-Jun-12	London
Principal Global Investors	Alternative Fixed Income	14-Jun-12	London
Kames Capital	High Yield	14-Jun-12	London
JPMorgan AM	Global Bonds	14-Jun-12	London
SKY Harbor Capital	High Yield	14-Jun-12	London
Coronation	GEM	14-Jun-12	London (Conf Call)
Morgan Stanley	Global	14-Jun-12	London
Henderson	Global Property	18-Jun-12	London
Deutsche Bank	Global	18-Jun-12	London
Pimco	Infation linked	18-Jun-12	London
Deutsche Bank	Global Bonds	18-Jun-12	London
Turner	Global / GEM	19-Jun-12	London
Global Borrowers & Investors	Global Bonds	19-Jun-12	London
Muzinich	High Yield	19-Jun-12	London
Global Borrowers & Investors	Global Bonds	20-Jun-12	London
Jupiter	Strategic Bonds	20-Jun-12	London
Paradice	Global Small Cap	20-Jun-12	London
Nomura	FX	21-Jun-12	London
Jupiter	Europe	21-Jun-12	London
Cohen & Steers	Global Property	21-Jun-12	London (Conf Call)
Fidecum	Europe	25-Jun-12	London
American Century	Global / GEM	25-Jun-12	London

	Long Only		
Manager	Asset Class	Date	Location
TwentyFour AM	RMBS	26-Jun-12	London
McKinley	Global / GEM	26-Jun-12	London
DePrince, Race & Zollo	Global / GEM	27-Jun-12	London
Schroders	Global Property	27-Jun-12	London
Macquarie	Infrastructure	27-Jun-12	London
Lapides	US Small Cap	28-Jun-12	London
BNY Mellon AM	Global Bonds	28-Jun-12	London
TwentyFour AM	RMBS	28-Jun-12	London

	Hedge Fund		
Manager	Asset Class	Date	Location
	Convert Arbitrage	13-Jun-12	London
	Macro	14-Jun-12	London
	REITS	20-Jun-12	London
	Convert Arbitrage	21-Jun-12	London
	Credit	22-Jun-12	London
	REITS	27-Jun-12	London
	Macro	27-Jun-12	London
	Convert Arbitrage	27-Jun-12	London
	Event	28-Jun-12	London
	Distress	28-Jun-12	London

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Under our multi-management arrangements, we selectively appoint underlying sub-investment managers and funds to actively manage underlying asset holdings in the pursuit of achieving mandated performance objectives. Annual investment management fees are payable both to the multimanager and the manager of the underlying assets at rates contained in the offering documents of the relevant portfolios (and may involve performance fees where expressly indicated therein).

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