OPTIMA®

Re-thinking Wealth Management Today

MARKET BULLETIN

Introduction

There has never been a more critical time than this period of economic crisis for financial service providers to reassess their Wealth Management programs. As portfolio losses mount, the confidence of many affluent clients in these programs, and by extension their sponsoring firms, has been severely shaken.

This crisis of confidence needs to be addressed if firms are to remain competitive in the business and not suffer significant client attrition when the dust settles. The initial step in this process is to reaffirm what works in the wealth management program and communicate this to anxious clients.

The next step is to consider the economic crisis as a stress test for the program and use it to expose deficiencies. Once these are identified, firms can take action to rebuild a program that better fits new financial market realities and shifting client demand. Our primary focus in this paper is with this second step.

Correctly Reading the Problem

In our view, the loss of confidence in wealth managers is not simply a knee jerk reaction by affluent clients to severe investment losses in an obviously adverse market environment. If this were the case, simple admonitions to "stick to the plan" and wait for the inevitable market rebound would suffice to solve the problem.

No, the cause of the confidence crisis is deeper. Confidence is shaken because client expectations, particularly regarding risk management, have not been met. In effect, the severity of recent investment losses has belied the core wealth management promise of a customized, needs-based program with clear risk boundaries and appropriately constructed portfolios generating returns within predictable ranges.

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We believe that most leading wealth managers understand this and will take steps to rebuild client trust by re-examining key components of their programs. These primarily include financial planning, investment management and governance.

Financial Planning

Financial planning is an essential component to any comprehensive wealth management program. Based on information elicited through formal client inquiries, plans identify clients' resource levels, goals and risk sensitivity. These determinations in turn guide and inform Investment Policy Statements and ultimately investment management strategies and recommendations.

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We are consultants dedicated solely to the financial industry. Since 1979, Optima Group has stood apart in providing insight-driven expertise, real-world acumen and creative excellence.

More sophisticated planning approaches typically measure risk tolerance through formal psychometric questionnaires. These "tests" classify people relative to their comfort level with assuming risk. Risk capacity is in turn measured through Monte Carlo simulations which measure a client's financial resource capacity to reach specified goals under various possible return scenarios. Together, these tools guide wealth managers in constructing an investment program that meets the parameters of both risk tolerance and risk capacity.

If this approach works, clients may be disappointed in periods of market declines and economic uncertainty, but they should not suffer significant anxiety with regard to reaching their goals. Nor should there be at any point an emotionally charged crisis of confidence in their wealth manager. If such reactions occur, the risk measurement system has failed either in properly evaluating the client or in following through with the appropriate investment program.

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We believe that the widespread weakening of confidence in wealth management engendered by the current economic crisis will drive wealth managers to critically review their risk measurement tools and processes. Likely steps include:

- Ensuring that risk management tools are applied in such a way as to produce genuine insight into clients' predispositions and are not used perfunctorily to meet compliance requirements.
- Re-examining risk tolerance measures to ensure accuracy and limit bias. This may include supplementing existing "hypothetical" questionnaires with an examination of actual client reactions to historical situations.
- Reassessing probabilities of loss by introducing more extreme outcomes into risk models. This revision may be accompanied by qualitative wealth manager-client discussions pertaining to the potential for highly volatile markets and unforeseen circumstances.
- Consideration of new approaches to risk assessment that utilize the notion of required risk, i.e., the level of risk necessary to meet specific goals given the client's financial resource level.

Targeted efforts to improve risk assessment techniques and practices will likely occur within the context of a broader effort to refocus client-facing representatives on risk profiles. These efforts will underscore the importance of accurate risk tolerance assessments and exhort advisors to consider risk tolerance and capacity from a fiduciary rather than sales perspective.

Investment Management

In wealth management programs, investment management follows directly from financial planning/profiling. Findings from the planning process are typically codified in an Investment Policy Statement (IPS) which functions as a blueprint for building a customized investment management program suitable to the client.

To earn and maintain the confidence of the investor in this program, the wealth manager must ensure that the investment approach is clearly within the predetermined risk parameters of the IPS, and that risk management measures are in place to guarantee continued compliance regardless of shifting conditions in the economy or financial markets. The recent crisis in client confidence suggests that wealth managers have not delivered on these commitments.

To redress these issues, we expect wealth managers to review essential components of the investment management process to determine deficiencies and adjust practices to conform to new market realities.

This review will likely include the following:

Asset Allocation

After the severe market corrections at the turn of the century, leading wealth management firms adopted and widely promoted a quasi-institutional approach to investing that was loosely characterized by two propositions:

- Given that financial markets are efficient, investment results are largely due to asset allocation rather than market timing
- Risk can be effectively managed through diversification

Wealth managers are not likely to abandon these beliefs entirely in response to the current market slide. However, we believe adjustments in implementation are likely. These may include:

An increased emphasis on tactical allocation

In practice, most wealth managers rely largely on strategic allocation for portfolio construction. This allocation approach sets more or less rigid, long-term parameters for asset distribution across asset classes. These parameters are set in line with client risk profiles based on historic returns of the asset classes included. Allocation levels are maintained over time through periodic rebalancing.

In advance of, and during, the current economic meltdown, wealth managers typically did not veer significantly from preset strategic allocations despite mounting losses. In some cases, rebalancing mechanisms were triggered that exacerbated the losses by buying into collapsing markets. To address such issues, we expect wealth managers to re-emphasize the role of tactical allocation under specified conditions. This would mean loosening strategic allocation ranges to allow for greater leeway in portfolio adjustments in response to market conditions.

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A reconsideration of what constitutes adequate diversification

Diversification is an essential tool in wealth managers' risk management arsenal. The current financial crisis, however, has led to a growing realization that many wealth management portfolios are not adequately diversified, i.e., that real risk levels are substantially higher than models suggest. Even portfolios that had been recently adjusted to include some "alternative" investments suffered greater than expected losses in recent quarters.

We believe that wealth managers will reassess their diversification models in light of recent asset class returns and will increase exposure to counter-cyclical investment vehicles in line with new market realities. The move to alternative asset classes had gained some traction in recent years, but we believe wealth managers will accelerate the process in pursuit of a more predictable needs-driven, total return approach to portfolio construction.

Products

A number of developments associated with the financial crisis and clients' loss of confidence will lead wealth managers to reconsider their traditional product mix.

Rising interest in countercyclical investments will likely drive managers to commodities vehicles including commodity index ETFs. Commodity ETNs got battered late last year on issuer and derivative concerns, but some wealth managers may reconsider these vehicles from higher credit firms like Barclays.

Use of index ETFs and other passive investments are likely to increase, driven largely by investor dissatisfaction with the results and added costs of active management.

In general, there will be a flight to safety in the near to intermediate term with an increased use of shorter-term income instruments and an avoidance of products that employ leverage. Structured products with principal protection should continue to be of interest, but transparency and simplicity will be essential elements to buyers.

The common use of open architecture programs, we believe, will continue. However, wealth managers are likely to review their manager search and selection processes with an eye to picking managers with acceptably stringent risk management programs. Wealth managers may also move to provide clients with greater transparency regarding manager selection and monitoring criteria.

Account Types

Most leading wealth managers have transitioned to the unified management account (UMA) structure over the last few years at the speed that technology has allowed. We expect this trend to continue and even accelerate through the current crisis.

The recent crisis will elicit an overall review of wealth management program fiduciary standards and governance support practices.

The UMA approach allows wealth managers to more effectively allocate client assets by integrating the broadest range of holdings in one comprehensive account. Better allocation leads naturally to improved risk management of the overall portfolio.

UMA structures with overlays also allow wealth managers greater control over external managers' investment selections. This permits improved tax management but it may also be beneficial should wealth managers apply restrictions for risk management purposes.

Governance

Even under normal circumstances, given the discretionary nature of wealth management programs, the substance, implementation and ongoing management of prudent fiduciary practices is critically important. Now, in this post Lehman/Stearns/Madoff environment, the role of good governance cannot be overstated.

We believe that the recent crisis will elicit an overall review of wealth management program fiduciary standards and governance support practices. Responsible firms will ensure that mechanisms to monitor compliance with standards are in place and fully functional and that any lapses are effectively redressed.

Firms are also likely to confirm their commitment to clients, high service standards and integrity through new communications efforts.

Summary Comments

The current economic and financial crisis is clearly stress testing even leading wealth management programs. Mounting losses with no clear end yet in sight are undermining client confidence in program sponsors and advisors. As a result, weaker programs and programs that fail to effectively respond to client concerns will likely suffer significant attrition.

In this paper, we have pointed to measures that we believe leading wealth management firms will take to successfully navigate through the crisis period and set their programs on firmer footing for longer-term growth. Naturally, each firm's reaction should be tailored to the specific strengths and competencies of the firm as well as the competitive context the firm operates in.

Optima Group, Inc.

Optima Group engages in ongoing, detailed competitive audits of leading wealth management programs. These audits uncover best practices across programs and provide a tool to industry participants to benchmark their offerings against those of key competitors. These audits also provide a foundation and starting point for outlining important changes that we believe leading firms in wealth management will make to survive the current crisis and remain competitive in their businesses post crisis.

Optima Group can help in reviewing the state of your wealth management program and can weigh your program against that of key competitors to determine where your program ranks and if it is keeping competitive with other industry leaders.

To discuss strategies to help your firm meet the challenges facing wealth management today, please contact:

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