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Private client wealth managers and family offices: Investing in alternative assets to increase returns

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Post-crisis flows into alternative asset classes have been driven by large institutions such as pension schemes, sovereign wealth funds, endowments and insurance companies, seeking reliable cash revenues and risk diversification beyond traditional funds, equities and bonds.

Both hedge funds and private equity are now looking after record assets. Assets in hedge funds pushed past $3 trillion, according to Hedge Fund Research[1], while Preqin reports private equity firms are running $2.49 trillion as of June 2016[2]. Flows are also a result of investors who, historically, may have avoided such asset classes, assessing the merits of allocating.

Private client wealth managers now face increasing pressure from their clients to deliver better performance. Analysis by PricewaterhouseCoopers (PwC) in its "Strategy and Global Wealth Management Survey 2016"[3] found only one third of wealth management clients were very satisfied with their wealth manager's service. This has led to wealth managers beginning to re-think -attitudes to alternative asset classes, such as private equity, Lombard loans, real estate, infrastructure investments, hedge funds and derivatives.

Global growth in the number of high net worth investors (HNWI) presents significant opportunities for wealth managers. A Capgemini study found North American HNWI wealth grew 2.3% to $16.6 trillion, while HNWI wealth in Asia-Pacific increased 9.9% to reach $17.4 trillion. European wealth currently stands at $13.6 trillion. While Europe's wealth grew, it did so at a rate below the global average because of the fragility of the region's economic recovery. It follows that wealth managers should offer a differentiated service and expose HNWI portfolios to asset classes outside of their traditional comfort zone.

The business case for wealth managers to move capital into these alternative asset classes is powerful, but it is something to be exercised with due caution and care.

The business case for alternatives

Alternative asset classes have traditionally been met with skepticism by some in the wealth management community. Widespread pre-conceptions about alternatives being high-risk, volatile, illiquid and expensive are being addressed. In fact, alternatives are specifically designed to manage risk and volatility and complement a diversified portfolio.

Inflows into alternatives continue to gather momentum. PwC estimates allocations will increase at a rate of 9.3% per year, resulting in Assets under Management (AuM) globally reaching $13 trillion by 2020.

It is true that hedge funds have faced criticism for post-crisis performance, and that their cumulative return calculations often incorporate excessive historical bias, but returns have been impressive over the last 12 months. Preqin puts performance for 2016 at 7.40%[4], while Hedge Fund Research reports the average manager delivered 5.6%, with equity and credit-sensitive event-driven strategies being the best performers[5].

1 https://www.hedgefundresearch.com/news/hedge-fund-industry-capital-surpasses-historic-3-trillion-dollar-milestone
2 https://www.preqin.com/docs/reports/2017-Preqin-Global-Private_Equity-and-Venture-Capital-Report-Sample-Pages.pdf
3 https://www.pwc.com/jg/en/publications/pwc-wealth-management-sink-or-swim-why-wealth-management-cant-afford-to-miss-the-digital-wave.pdf – p23
4 https://www.preqin.com/docs/reports/2017-Preqin-Global-Hedge-Fund-Report-Sample-Pages.pdf
5 https://www.hedgefundresearch.com/family-indices/hfri

Protecting investors from inflationary risk is critical given the potential inflationary impact of Brexit and the new US Administration's economic and spending policies.

Private equity is also performing strongly, with Preqin stating investors into the asset class have seen annualized returns of 16.4% in the three years to June 2016, the highest among any private capital strategies[6]. The Private Equity Growth Capital Council (PEGCC) also indicated that private equity returns surpassed public markets over both short-term and long-term horizons[7]. The report notes the median private equity benchmark reported returns of 6.5% for the year ending September 30, 2015, putting it ahead of public market returns of -0.5% and -0.6% for the Russell 3000 and S&P 500 indices. The report added that the median private equity benchmark achieved an 11.8% annualized return over a 10-year time horizon, almost double the 6.8% delivered by the S&P 500.

Real estate and infrastructure investments offer benefits too. Monetary policy pursued by central banks globally makes it hard for investors to obtain yield, but infrastructure is considered to be a broadly reliable source of fixed income returns, which rise in line with inflation. Protecting investors from inflationary risk is critical given the potential inflationary impact of Brexit and the new US Administration's economic and spending policies. Admittedly, infrastructure is susceptible to regulatory risks, but it is becoming an increasingly popular asset class for long-term investors.

Developing the wealth operating model to support alternative investments

Alternative investments, unlike publicly traded securities or daily dealing asset managers, require wealth managers to possess specialist knowledge and expertise if they are to provide a strategic benefit opportunity for HNWI portfolio diversification. This comes at a sensitive time as wealth managers face significant cost-income pressures.

Analysis by Oliver Wyman of a sample study of wealth managers globally found cost-income ratios stood at 77% in 2015, an increase from 69% in 2007. The Oliver Wyman study found US wealth managers had a cost income ratio of more than 80% whereas Europe's stood between 60% to 80% depending on the onshore/offshore split and the client segment focus. In Asia, local wealth managers have a cost income ratio of between 60% to 80%, although global players in the region will typically have cost income ratios exceeding 90%. This discrepancy is primarily a result of global wealth managers' expansion costs in the region, and the expense of establishing a business, whereas local providers will be firmly bedded down.

6 https://www.preqin.com/docs/samples/2017-Preqin-Global-Private_Equity-and-Venture-Capital-Report-Sample-Pages.pdf
7 http://www.investmentcouncil.org/private-equity-returns-far-exceed-declining-market-returns-on-multiple-time-horizons/

Much of the added cost/income pressures emanate from enhancing operating models to ensure best of breed risk management and controls as a consequence of regulation. The US Department of Labor's new fiduciary rule obliges wealth managers to ensure they act in clients' best interests when offering investment advice, as opposed to simply selecting investments deemed "suitable." Whilst the new US Administration has put this rule-change on hold, the EU's Markets in Financial Instruments Directive II (MiFID II) and the UK's Retail Distribution Review (RDR) impose restrictions on investment advice. Attaining readiness for these rule changes is expensive, and further inflates cost pressures.

Understanding alternatives and putting reporting systems in place to monitor underlying investments can be complex, particularly if wealth managers do not have internal expertise in illiquid strategies such as private equity, credit and debt. The speed at which new asset classes and fund structures emerge can also pose challenges for investors as they need to get to grips quickly with the concepts behind them. The rise of private debt funds or direct lending funds may require an investor looking at these asset classes to appoint an individual with a credit or loans background to monitor such allocations, for example. This comes at cost.

As more wealth managers enter into derivative transactions to hedge risks and liabilities, they will be subject to various regulations such as the European Market Infrastructure Regulation (EMIR) and margining requirements for bilateral over-the-counter (OTC) derivatives. They may also be required to clear these transactions. This will require wealth managers to manage and source their collateral efficiently so they can meet their margining commitments. Undertaking collateral management internally comes with huge process change and investment, and some firms may prefer to outsource the task to a third party.

At the same time, HNWI investors are becoming "increasingly digital" and want their wealth managers to report on their investments in near real-time, irrespective of asset class complexity. Spreadsheets no longer cut it. Wealth managers intending to invest client funds into alternative assets should evaluate technology and service platforms from vendors demonstrating an extensive pedigree in both alternative and traditional assets and which can provide wealth managers with expertise and scalable, flexible technology to execute reporting requirements for alternative assets.

Conclusion

Traditional stock and bond portfolios have provided desultory and, at times, volatile returns. Consequently, HNWI and UHNWI investors and leading family offices are seeking risk diversification and reliable return generation from alternative investments. Wealth managers are beginning to take note, increasing exposure to alternatives across the spectrum. Those that ignore alternatives may find themselves at a competitive disadvantage.

SS&C is a global leader in the provision of technology platforms and outsourced services for wealth managers who invest private client money in both alternatives and traditional asset classes. For more information, please contact **solution@sscinc.com**.

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