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FIRMS CAN ACT TO REBUILD SHAKEN INVESTOR CONFIDENCE THROUGH MORE HOLISTIC RISK MANAGEMENT

The dramatic downturn in 2008 severely shook the confidence of HNWIs in the ability of traditional risk management practices to mitigate their downside exposure. Wealth management firms acknowledge confidence is shaken, but many still underestimate how the erosion of trust has and could affect client relationships.

To assuage HNWI concerns and restore their confidence, firms may need to re-evaluate how best to align their clients' financial/risk profiles and personal goals with their true risk appetites. This will likely involve improving firms' due diligence practices, and building more comprehensive risk assessments.

2008 PROMPTED HNWIs TO QUESTION THE STRENGTH OF PORTFOLIO RISK MANAGEMENT PRACTICES

Risk management frameworks are deployed at many levels in financial institutions—from the enterprise-wide to the product levels—but we are largely talking here about the frameworks that apply to HNWIs individuals, their personal risk profiles, and the portfolio-construction process. The unprecedented events of 2008 rattled investors in general, but the following issues (separately and together) served in particular to undermine HNWIs' trust and confidence in the adequacy of wealth management firms' due diligence and risk practices in assessing and managing their portfolio risks:

- The widespread investment losses incurred by firms around the globe eroded confidence in financial institutions—most of which were struggling to manage their own portfolios, and swallow massive write-downs.
- Many firms, it transpired, had failed to assess and fully convey to clients the implications of product risks. HNWI client portfolios suffered as products and asset classes failed to behave as anticipated—in outright performance, and compared to the risks implied in their credit ratings. For instance, some firms lumped together an extensive range of diverse products into a single category, such as putting U.S. Treasuries and certain structured products into a "fixed-income" bucket. Even when such products were comparable from a credit-ratings standpoint, some key inherent characteristics, such as liquidity, potential downside and complexity, were different.
- Weaknesses in due diligence and risk assessment practices also came to the fore, negatively impacting clients, when it appeared many firms had failed to recognize market fraud. For example, in the aftermath of various high-profile global fraud cases, such as the Ponzi schemes perpetrated by Bernard Madoff ($65 billion) and Allen Stanford ($8 billion), some clients discovered they had been exposed to these schemes via their Advisors without even realizing it. This issue may have demonstrated a lack of watchfulness and communication by some wealth management firms and Advisors.

These issues confirm the need for due diligence of products to be done by an independent assessment group to help ensure the risk profile of products is thoroughly evaluated.

Our research[84] confirmed the extraordinary circumstances of the crisis negatively impacted perceptions of firms' due diligence and risk management practices. Both Advisors and HNWI clients ranked risk management and product due diligence capabilities as one of the top reasons clients chose to stay with or leave a wealth management firm in 2008. Nevertheless, many Advisors underestimated that very client need. Of HNWI clients surveyed, 73% said risk management and due diligence capabilities were an important factor in their decision to stay with their firm in 2008, while only 54% of Advisors said it was a reason clients did and would stay.

Moreover, many wealth management executives overestimated the quality of their firm's due diligence and risk management capabilities. For instance, when asked about these processes, 50% of surveyed executives said they were satisfied with the current quality, compared to 40% of Advisors. This may be because executives believe that their firms execute their risk processes diligently, but that the analyses themselves are overly simplistic, resulting

[84] Research compares responses to the same question in the Financial Advisor and Client Surveys—see methodology

in a systemic failure to deliver investor risk profiles of the quality sought by clients and Advisors. For example, some wealth management firms only employ basic profiling categories that peg an individual's risk tolerance somewhere on a scale from "Aggressive" through "Moderate" to "Conservative". A more comprehensive risk assessment would help them understand client risk appetites on a far more granular level.

Firms clearly need to close any gaps between perception and reality as to risk and due diligence capabilities—both by improving those processes, and by doing a better job of communicating to clients the specific risk implications of different products, and the risk-weighted role played by such products in a given portfolio. The need to understand the risks of each product, and communicate the implications thoroughly to clients, could be especially challenging for Advisors who use open product architectures with access to a wide variety of products from different sources.

COMPREHENSIVE RISK ASSESSMENTS ARE FUNDAMENTAL GOING FORWARD

In the last two downturns, the portfolios of HNWIs who had gone through a comprehensive risk assessment fared better than those of HNWIs who did not. Research shows, for example, that during the 2000-02 technology bubble downturn the portfolio of a HNWI who completed a comprehensive risk assessment would have lost 6.1%, whereas a more conventional risk assessment for the same HNWI would have resulted in a 15.1% loss.[85] Similarly, HNWIs who took advantage of a comprehensive risk assessment in 2008 suffered smaller losses than those HNWIs who did not.[86]

A comprehensive risk management assessment can be characterized by three key elements:

1. **Behavioral finance** is a relatively new field that encompasses "soft" factors, such as the emotion around economic decisions—emotion that is known to skew perceptions about risk. Behavioral-finance approaches provide a more complete picture of the way clients make investment decisions. This provides a richer level of detail that makes it possible to go beyond the traditional "Conservative", "Moderate", and "Aggressive" portfolio-model labels often used for individuals.
2. **Scenario analysis** can be used to assess and communicate to clients, in a thorough but simple way, the potential impact of extreme scenarios on a portfolio —from market trends to personal events like loss of income. This assessment should go beyond traditional measures such as standard deviation, to provide a detailed picture of extreme scenarios, including potential cumulative losses over a period of time. Moreover, scenario analysis can leverage elements from behavioral finance to show clients the potential dollar amount at stake whether a position's value goes up or down. This is especially helpful because evidence suggests losses elicit a far greater negative reaction in investors than the positive reaction produced by gains of the same magnitude.
3. **Deeper diversification** refers to an exhaustive and granular analysis of a wide range of asset categories and products, which avoids generalization and increases the transparency in the client portfolio. Diversification should occur not just along asset classes, but *within* asset classes. For example, this type of approach can draw a distinction between the role of "fixed income" in a portfolio designed to generate future returns vs. one designed to preserve capital. Moreover, deeper diversification should generally be better able than a random set of overlapping investments, or even a portfolio allocation model, to create a truly diversified portfolio. For instance, it could be said that virtually any equity portfolio lost money in 2008, regardless of its regional, company size or industry focus, while deeper diversification helped investors who also had solid allocations in gold and U.S. Treasuries to cushion the losses.

These elements can lay the foundation of a holistic risk assessment, which also incorporates a thorough understanding of clients' financial and personal goals. Accordingly, a client might initially identify him or herself as a "Moderate/ Aggressive" investor, but might reconsider their position after learning the potential portfolio impact of a confluence of events like loss of income along with unexpected market losses. As a result, the investor might put more emphasis on containing personal risk, and less on pursuing returns (which may also involve more risk). This shift would clearly change the Advisor/firm approach to portfolio design and execution for that HNWI.

Additionally, looking at client risk by portfolio value alone is probably not sufficient. Understanding the client risk in totality, at their total wealth level is also important. Clients' liquidity needs, income requirements, time horizons, risk tolerance need to be integrated into the full risk assessment along with performance expectations.

[85] Chhabra, Ashvin, "Beyond Markowitz – A comprehensive Wealth Allocation Framework for Individual Investors", Merrill Lynch. 2005
[86] Christopher Wolfe, Managing Director, Merrill Lynch. Interview by Capgemini, April 2009.

USING HOLISTIC RISK ASSESSMENTS CAN ADDRESS CLIENT RISK PROFILES IN A MORE INNOVATIVE WAY

Ultimately, then, holistic risk assessment can directly drive the portfolio-construction and investment advisory-process (see Figure 18).

The HNWI's appetite for personal, market, and aspirational risk are weighed against their precise goals and needs—after full disclosure of the potential risks and dollar impact of e.g., a confluence of events or extreme scenarios.

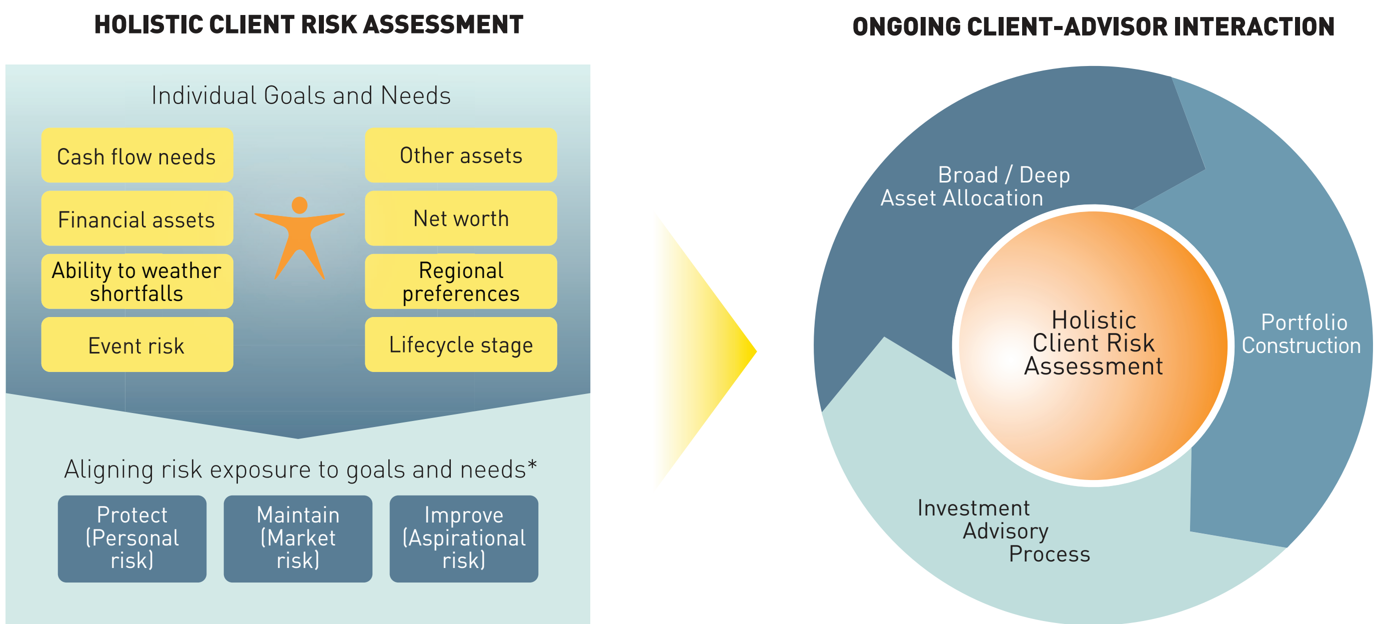
A thorough holistic risk assessment could help ensure the subsequent, inter-related phases of the portfolio-management and individual risk profiling process will be more effective. Those basic stages are:

- **Broad and deep asset allocation,** i.e., finding the most suitable combination of a wide range of asset classes and products therein, given the holistic risk assessment.
- **Portfolio construction,** i.e., allocating investments to specific products whose risks and function the client fully understands. The Advisor or investment-team role is essential in helping ensure the selection is done in a strategic way, in line with deep diversification processes, and a proper risk-appetite appraisal—in the context of the client's total level of wealth.
- **Investment advisory process,** i.e., creating an ongoing relationship with the client to monitor portfolio performance—not just of the portfolio itself, but against the client's total wealth picture, so adjustments can be made for changing life events and needs, and evolving market conditions.

Several wealth management firms are already leading the industry in helping their HNWI clients to understand their true risk tolerance through these kinds of deeper assessment processes. These innovative processes help firms to understand how clients emotionally process and make decisions about preserving, maintaining, and growing their investments.

By participating regularly in holistic risk assessments, HNWIs are likely to feel a far greater level of confidence in the risk management and due diligence practices at their wealth management firm. They will also be better informed, and more qualified to participate directly in creating their own personalized investment strategy. For wealth management firms, then, stronger and more comprehensive risk assessments are a cornerstone of regaining HNWI client trust.

Figure 18. Holistic Client Risk Assessment as a Core Element of Ongoing Client-Advisor Interaction



***Note:** "Protect" goal refers to client desire to minimize losses in falling markets; "Maintain" goal is to minimize risk during unremarkable markets (e.g., using a deeply diversified portfolio); "Improve" goal is to maximize returns in rising markets

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- 10,070 gallons of water were saved.
- 16,638 pounds of global warming gases were avoided.
- 23,879 kilowatt-hours of energy were saved (8,200 kWh of energy can heat and cool an average US home for one year).
- 389 cubic feet of solid waste were kept out of a landfill.

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