

Advisory services go high profile

The last financial year has left wealth managers with a lot to ponder over the Christmas break. **Didier Pitton**, product marketing director at Odyssey Financial Technologies, looks at winning business models for 2009 – and argues that private bankers should consider revisiting the way they provide investment advice

As private wealth management firms feel the impact of the dislocation in financial markets, investment profiling has become essential to the provision of investment advisory services, helping advisers meet regulatory obligations, manage risk and ultimately increase revenues.

This year private investors and wealth managers have faced an unprecedented challenge. Private wealth management revenues have declined and the value of assets under management has fallen due to the negative performance of some investments.

Attracting and retaining clients has become increasingly tough. Clients are paying greater attention to their investments due to market volatility and are more demanding than ever. There is a huge appetite for information on risk and a flight to safety with investors taking their business to more conservative financial institutions. In addition, the trend towards holistic advice by a trusted adviser has taken a knock. Clients have lost confidence in single providers and are spreading their risk with a larger number of financial institutions.

Many wealth managers have been blamed for the poor performance of clients' portfolios. In order to prevent more fallout and potential legal action, wealth management firms will need to implement stricter processes to protect private investors and to ensure investors understand and manage their portfolio's risk.

In addition to advice, clients want greater involvement in investment decisions and more regular and in-depth updates. Detailed guidance is needed on the risks of investment strategies, the instruments proposed, how risk materialises and how abnormal market conditions could impact portfolios.

Redefining advisory services

Wealth management firms must redefine their investment advisory service – what does the service exactly include and how is advice provided? What commitments do firms make to their clients in terms of monitoring and information? How do we charge for the service? It is crucial for firms to define their service-level agreement (SLA) for investment advisory highlighting the benefits of their advisory services over execution-only services and encouraging

execution-only clients to move to advisory relationships.

Investment advisory services result in better investment decisions and have a positive impact on clients' investments. In addition, research shows that by converting clients to a structured advisory relationship and setting out an investment strategy, financial institutions improve revenues, build immunity to difficult markets and increase investment returns for clients.

One of the key elements of the investment advisory SLA is investment profiling. As the cornerstone of investment advice, investment profiling consists of understanding a client's risk tolerance in relation to his or her current financial situation and future financial needs, and then proposing the most appropriate risk profile and related asset allocation.

Another important element of the investment advisory SLA is portfolio monitoring. Wealth managers must constantly monitor client portfolios against the agreed investment strategy and take action if significant differences are revealed in order to protect the client's interests.

Explaining risk to private investors

Attitudes to risk have changed overnight and investors are making significant adjustments to their portfolios. The use of increasingly sophisticated products within portfolios has also impacted the way in which risk is perceived.

Advisers can effectively help clients to manage portfolio risk by establishing a "risk budget" with them. This budget, which can be expressed in percentage of "value at risk" (a well known and accepted risk analytic), can be used as a limit for the portfolio construction and management. If the markets become riskier, the "value at risk" may exceed the agreed budget and require adjustment. This helps to identify which positions and classes have biggest impact on the global risk of an investment portfolio and, therefore, need to be reduced.

The advice procedure can be enriched with 'what-if?' analysis and risk suitability checks. This allows advisers to test trades before formally proposing them to clients, so the resulting portfolio snapshot is compliant with its risk tolerance budget. In such cases, risk

is used as a decision support tool to identify which positions and asset classes contribute most to the global risk of a portfolio (so they can be reduced or increased) and, secondly, to simulate the impact of a series of buy and sell orders on the risk of the portfolio.

Several financial institutions providing wealth management services have already gone through the re-definition of their SLA for investment advisory with considerable success.

In order to scale investment advisory services (for example, to offer the service at a reasonable cost while respecting the commitments of the SLA) most firms have implemented business technology to allow wealth relationship managers to automate a large proportion of the work and meet regulatory and compliance obligations.

Protecting portfolios

Rigorous asset allocation and the use of quantitative risk analysis has proven to be the best way to protect portfolios (relatively) from dramatic falls in stock and corporate fixed income markets.

While asset allocation has not avoided negative returns, it can reduce the level of loss and the volatility. Odyssey's client research shows that private investors with no asset allocation suffer more than those with an asset allocation due to a lack of diversification and poor risk management.

Numerous studies demonstrate that asset allocation contributes to portfolio management performance much more than product selection (picking).

In the aftermath of the 2008 financial crisis, destabilised more risk-averse clients are demanding more than just execution-only services and basic investment advice. They are looking for structured high-quality investment advice and are prepared to pay a fee for it if financial institutions are able to demonstrate the added value of their service and commit to well defined service level agreements.

Winners in the post-2008 financial crisis will be those private wealth management institutions that re-visit the way they provide investment advice and take this critical service to a new level. ■