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# The Alternative Challenge

**By Anthony McNaughten**

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***Anthony McNaughten discusses the considerable challenges facing traditional managers of private wealth – changes in organisational structure but, first and foremost, the essential shifts in attitude necessary within their organisations if they are to serve their clients effectively.***

The increasing use of alternative investment strategies by private banks and private wealth managers is symptomatic of the fundamental changes sweeping the asset management industry. The internet is giving private clients access to information and analysis of a quality previously only available to institutional investors. As clients are exposed to greater competition, are better informed and more discriminating, established providers are under pressure to justify their charges through more innovative, value-added products and services. Many clients, enthused by the availability of information, want to take a far more active interest in the management of their assets. As global investment strategies become the norm the viability of directly invested discretionary portfolios as opposed to funds is increasingly questionable. The demand for performance measurement has put immense pressure on managers to deliver institutional quality asset management, which generally means more centralized asset allocation and stock selection.

The advent of the index tracker has undermined the mystique factor in active management. Increasing numbers of institutional and private clients are opting for tracker funds for their core portfolios on the basis that they are unconvinced by the claims of long only managers that they can outperform the markets.

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The fact is that the perceived value of traditional investment management is being called into question as most managers play for safety, constructing portfolios so close to the relative indices that they are closet trackers themselves. Private wealth management institutions are fighting back by trying to offer higher value services. These services include more broadly based wealth management advice. Many encompass tax planning, property and commodities as well as providing more independent advice and access to a choice of third party managers – and more innovative products such as multi manager funds, hedge funds, private equity and derivative-based investments and hedging products.

In general, the products are designed to give clients and their advisors greater flexibility in constructing investment portfolios with a view to achieving one or more of the following:

- Greater choice of managers and strategies (third party funds and multi-manager funds)
- Lower risk (principal protected, derivative-based structures for hedge funds);
- Higher returns for higher risk (private equity, individual hedge funds);
- The ability to back their own market judgement and take a 'punt' (options and warrants);
- Ability to protect portfolios against market risk (various derivative products and portfolios consisting of various alternative assets and strategies.

There have been a number of driving forces behind the move to alternative investments, particularly during the later half of the 1990s when a positive inflation outlook and declining interest rate environment led many investors and product providers to search for investments with higher potential returns. Europe's investment culture had been predominantly bond and bank deposit orientated. Convincing retail and private investors to plunge directly into equity portfolios was made easier through the application of derivatives to create equity linked, principal protected funds, bonds and deposits.

More recently, there is the belief that blue chip stocks and index funds cannot continue to deliver the returns of recent years. There are views that the boom is so called dot-com stocks is an accident waiting to happen with further concerns that the market has become over dependent on the technology, media and telecom sectors. These factors have re-ignited interest in principal protected structures.

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Investors want consistent, sustainable returns. With concerns over equity and bond markets due to rising interest rates, investor focus has extended to assets with low or even negative correlation to traditional asset classes. In other words, the focus is on assets that won't necessarily move in the same direction as the traditional asset classes and may even more in the opposite direction. Adding such assets to a traditional portfolio, gives investors the potential for similar or even higher returns but with lower risk.

This helps to explain the growing interest in hedge funds from private and institutional investors alike. The key difference between traditional investment funds and hedge funds is the flexibility hedge funds have at their disposal. They employ a broader range of trading or investment strategies using a wider range of investment instruments to take advantage of changing market conditions. Their ability to take long, short or market neutral positions enables them to diversify away more risk if required.

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Many clients may have been put off by the adverse publicity attached to these new products, such as the recent scandal of the Manhattan and Cambridge funds, where alleged fraud has resulted in investors losing millions.

In spite of this, many of the largest and most sophisticated investors have been convinced of their benefits for some time and the performance of hedge funds generally supports the view that they are, on average, less risky than conventional portfolios. As at the end of February, with the Dow Jones Industrial Average down nearly 12% and the MSCI World Index down 5.60% the CSFB Tremont Hedge Fund Index was up 6.40%, clearly highlighting the benefit of diversification with hedge fund investing.

Demand for alternative investments is almost certain to rise quite steeply. Client research for management consultants Maslinski Lawrence suggests that most private clients are receptive to some of these products, provided their attributes are properly explained. A competent and trusted advisor can overcome the inevitable prejudices stemming from any adverse publicity. Some investors are also willing to take higher risks with a portion of their portfolio. There is a marked increase in demand for private equity as evidenced by the growing number of venture capital and leveraged buyout specialists setting up shop across Europe.

The problem for many asset managers is that, while they recognize the increasing role of alternative investments, they are institutionally wedded to the traditional portfolio product. Introducing new concepts into this very traditional culture is no simple task.

The problem for most established institutions is that successfully adding alternative investments to a conventional product range requires considerable management commitment to achieving a quite fundamental cultural change. The role of alternative investments in the client management strategy must be clearly defined and supported at all levels. There must be recognition that investment will be required to put in place the necessary product infrastructure and client communications while the scale of initial demand from existing clients may be difficult to predict.

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A product development strategy must be agreed, setting out a basis of priority. Specialist expertise will be required for ongoing development of new products. Decisions must be made as to whether expertise should be internal or outsourced. Policy regarding private labelling externally sourced products versus marketing third party names will need to be set.

A concentrated programme of client communications and relationship manager training will be essential for successful and appropriate marketing. Internal support processes will have to be defined and put in place specifying the respective roles of product specialists and relationship managers.

Those who are familiar with traditional private client institutions will understand the internal barriers that need to be broken down in this process. Front line client managers, quite reasonably tend to be possessive about client relationships built up over many years. They will often be suspicious of newly recruited specialists trying to sell innovative products. They don't want their clients sold products that may undermine the trust they have fostered and will take some persuading to cooperate

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The internal management task poses a considerable challenge to most private client institutions.

But while they are coming to terms with this challenge, their clients and contacts become increasingly vulnerable to more innovative and fleet-footed competitors. It would be quite wrong to suggest that established private investors are all about to change the habits of a lifetime. Yet the trend towards alternative investments is clearly established. Institutions that fail to respond will, to say the least, find it increasingly hard to compete for new clients in the future.