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Proposing an investment management solution for trustees and clients

In this, the second of four articles in Private Client Practitioner by UBS Wealth Management, the issues of risk and return are examined in relation to the strategic and tactical asset allocation process that forms the basis of a discretionary managed portfolio

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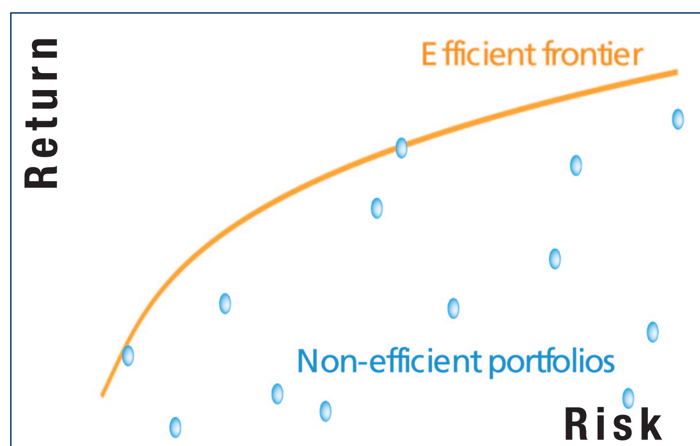
The first article 'Understanding the needs of trustees and clients' introduced a number of key considerations that trustees and beneficiaries face in the investment management of trust portfolios, and explained that rather than offer a range of standard products, UBS Wealth Management uses a four-stage approach. The first of these stages is understanding – not just the trust environment but the profile and objectives of the trustees and beneficiaries.

This important period of discussion and consultation sets the scene for the collaborative relationship that ensues. The profile and objectives of the trustee and beneficiary are explored in detail and take account of all parties' attitude to risk, the period of time over which the portfolio will be invested, whether or not there is a requirement to make capital withdrawals (and the likely amounts) and more. Only then does UBS develop an investment proposal – stage two – and replay their understanding to the trustee to ensure that they agree on direction.

The risk profiling process is of critical importance in the preparation of an investment proposal. No two trusts are alike and assessing risk tolerance so that the required wealth management goals may be properly defined is the first step. This process enables investment managers to understand how each trustee defines risk and what their return objectives are. Investment managers' ultimate objective is to create an 'efficient portfolio'. By this, we mean one with a maximum return for a given level of risk, or a minimum risk level for a given expected return. Sometimes referred to as the most efficient risk adjusted return.

Of course, different asset combinations lead to different risks and returns, whereas a client's risk preferences usually remain constant. The challenge is to find the optimal allocation of the various different asset classes. In modern portfolio theory this is described as the 'efficient frontier' i.e. the relationship between the return that can be expected from a portfolio and the riskiness (volatility) of the portfolio, which can be drawn as a curve on a graph of risk against the expected return.



It is worthwhile reminding ourselves at this point that the purpose of risk management is not to minimise risk but to monitor the levels and sources of risk to make sure that they match expectations. Risk is necessary in order to drive returns and needs to be allocated in such a way as to maximise expected returns, which brings us to the subject of 'risk budgeting'.

Risk budgeting is the assessment of the amount of risk to be employed, and where it is applied. It is nowadays considered by investment experts to be the second most important factor after asset allocation in portfolio management.

So, how does it work? Investment managers divide their investment decisions across many different decision areas – currency, duration of investment, security selection – to diversify the sources of excess return. 'Tracking error targets' are attributed to each decision area in order to spread the tracking error budget agreed with the client in terms of an agreed percentage. This risk budget percentage is usually agreed at the total fund level. It is the maximum standard deviation (which is evaluated in advance) of the difference between the asset return and the return on the 'liability benchmark'. The liability benchmark is the notional portfolio of assets that exactly matches the expected liability cash flows.

Once the risk budget is agreed, the process of allocating it begins, and strategic asset allocation follows. The risk profiling and risk budgeting processes define the framework for strategic asset allocation, a process which in itself, requires examination of risk-return characteristics for each individual asset class, security selection and market timing.

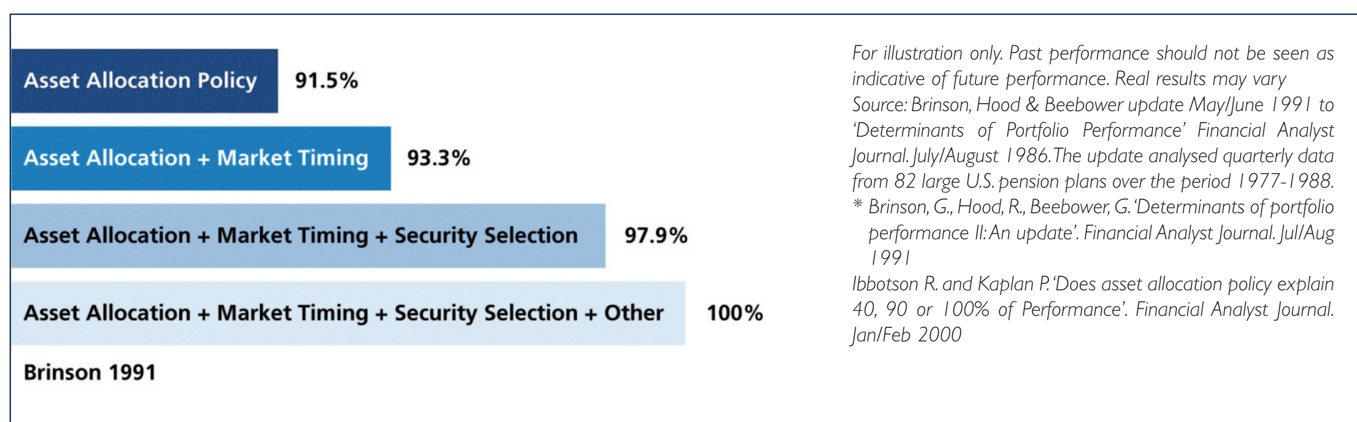
Two decades of academic studies have shown that asset allocation accounts for most of the variation in portfolio returns. This does not mean that security selection and market timing add no value to investments. However, for long term purposes, they play a less important role than strategic asset allocation in meeting financial goals.

Once a strategic asset allocation is agreed, a tactical overlay can be applied to benefit from various stages of the market cycle. The ultimate goal of tactical asset allocation is to profit from short-term investment opportunities without putting the overall risk-return profile at risk. As soon as an opportunity has been identified, the portfolio would deviate from its long-term strategic asset allocation to take advantage of this. Tracking error budgets are set for each investment model in order to ensure that the resulting portfolio is in line with a client's risk profile. The size of the tracking error increases proportionally with the risk of the model.

The combination of UBS Wealth Management's in-depth risk profiling, rigorous investment research and due diligence, and multi-asset-class approach ensure that trustees may be confident their objectives are met. When an investment proposal is presented, it typically includes recommendations on strategy selection, asset orientation (international/domestic), reference currency (sterling, US dollar, euro), time horizon (long term), with an explanation on why the strategy has been proposed. It also highlights any inconsistencies and risk warnings. Importantly, it includes statements that solicit the trustees' agreement to ensure that the correct interpretation of the needs and goals has been achieved.

While predicting precisely which asset class will do best in the future will always be challenging, the benefits of a robust and disciplined approach to investing that starts with understanding needs and goals, are clear. And an investment proposal that plays back an interpretation of these requirements and objectives, outlining in detail the strategy and solution, and highlighting any perceived inconsistencies or risk factors, creates the right environment for a good outcome as well as a productive, long-term relationship.

In the next article, we look at the third step in the four-stage process – implementation – and examine the process of strategic asset allocation in more detail.



For illustration only. Past performance should not be seen as indicative of future performance. Real results may vary
Source: Brinson, Hood & Beebower update May/June 1991 to 'Determinants of Portfolio Performance' Financial Analyst Journal. July/August 1986. The update analysed quarterly data from 82 large U.S. pension plans over the period 1977-1988.
** Brinson, G., Hood, R., Beebower, G. 'Determinants of portfolio performance II: An update'. Financial Analyst Journal. Jul/Aug 1991*
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