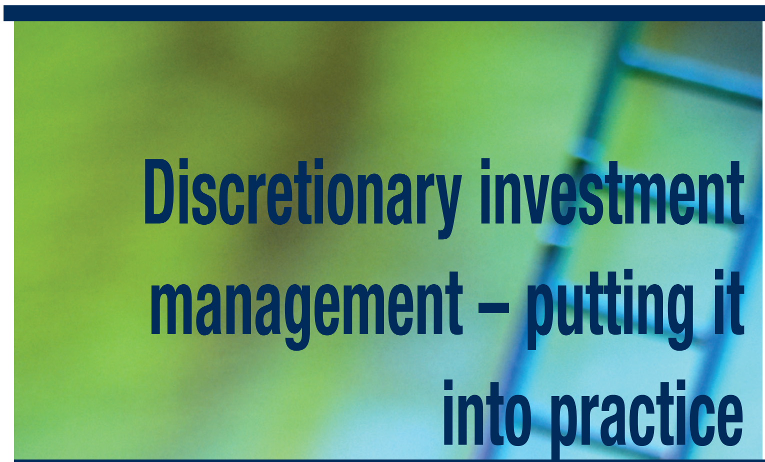

Discretionary investment management – putting it into practice

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What does implementing a discretionary managed portfolio involve? How do investment managers allocate assets and select relevant financial instruments? And what lies behind their decisions? This article, the third of four in Private Client Practitioner by UBS Wealth Management, focuses on the implementation of a discretionary portfolio – one of the components in the four-step process UBS uses to meet the needs of trustees: Understand, propose, agree & implement and review.

In short, implementation involves strategic and tactical asset allocation, and product selection – it means combining all sources of potential return and putting into practice the strategy that the investment manager has discussed and agreed with the trustee in order to meet the financial needs and goals of the beneficiary. A process of consultation, analysis and discussion will have preceded this step and a number of factors taken into account: 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), medium and longer term objectives. In many instances there will have been several meetings to fully understand the needs of the Trustees in the responsibilities they are charged with delivering to the beneficiaries.

The risk profiling process is of critical importance; assessing risk tolerance so that the required wealth management goals may be properly defined enables investment managers to start building a picture of how they will be attained. An investment manager's 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 an expected return, sometimes referred to as the most efficient risk-adjusted return. Of course, different asset combinations lead to different risks and returns; and different financial instruments are used to achieve returns that take account of variable market conditions. The challenge is to find the optimal allocation of the various different asset classes and once a strategic asset allocation is agreed, a tactical overlay can be applied to benefit from various stages of the market cycle. This may sound straightforward enough, but with an increasing number of viable asset classes – ranging from cash to any number of commodities and real estate – a growing number of funds, including hedge funds and funds of hedge funds, and other financial instruments, this is quite some challenge.

Investment managers are required to know and understand in detail precisely what each of these options has to offer before they can select the most appropriate of these for their client and in the right proportions. They need the very latest research and market intelligence from around the world, the ability to construct a portfolio and deploy the right strategy, and the experience, specialist knowledge and expertise in order to select the appropriate instruments. Charities and private clients can nowadays avail themselves of products and services that were previously only available to an institution, which means there is an even greater and potentially bewildering scope of financial instruments that warrant investigation.

UBS draws on its global research and intelligence resources, teams of specialist investment experts from across the group (Wealth Management, the Investment Bank and Global Asset Management) and adopts a robust manager selection process that combines qualitative and quantitative techniques. Products from inside and outside UBS are selected based on strict performance criteria and sophisticated financial modelling techniques are used in portfolio construction to rigorously test proposals. This 'open architecture' approach to product selection means UBS draws on the full range of financial instruments to create an optimal solution.

Through tactical asset allocation, the active management of a portfolio rebalances the percentage of assets held in various categories in order to take advantage of market pricing anomalies or strong market sectors as they arise. This enables portfolio managers to create extra value by taking advantage of certain situations in the marketplace. It is a moderate approach in that managers return to the portfolio's original strategic asset mix when desired short-term profits are achieved.

Product selection is key: property, hedge funds and commodities, where suitable, are increasingly regarded as essential components within a portfolio as they facilitate a much broader range of investment opportunities, which as part of a well diversified portfolio can help to improve the efficiency of returns by reducing overall volatility. Hedge funds, for example, generate their returns from temporary price imbalances and have less correlation to movements in the overall market, offering opportunities even when the market may be in decline. Hedge fund-linked products can access both financial and non-financial (e.g. commodity) markets. Importantly, they can take long, short, spread, and option positions in any of these markets. A diversified portfolio that includes non-traditional investments can both improve the portfolio's risk/return efficiency and stabilize its performance.

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 – reducing exposure when recent market performance has been good, and increasing exposure in a slipping market. The implementation process consequently involves technical analysis, econometric models, examining liquidity trends, seasonal patterns and valuation ratios for stock markets, government bonds, foreign currency, and investing styles.

At UBS, tactical asset allocation and product selection decisions are made by the UBS UK Investment Committee based on global research and our strategy outlook. In contrast with portfolios that are managed by an autonomous single portfolio manager, the result is a team-based, robust and disciplined process which adapts UBS's global views to meet specific needs. It ensures that the tactical asset allocation ranges do not overlap with other model allocations or exceed the overall tracking error of the risk profile.

Trustees are presented with the reasoning behind the underlying investments that populate the proposed portfolio and investment decisions are implemented quickly, with orders bundled together where appropriate, to help ensure that trustees and beneficiaries benefit from attractive terms. Investment success often hinges on rapid transaction processing, especially in the case of short-term market opportunities. Once this is achieved, the process of management, monitoring and review begins.

In the fourth and final article in this series, we look at the 'review' step in the four-stage process and examine how important it is to conduct reviews on a regular basis and from a number of different perspectives.

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