Investment Advisory in Today’s Markets

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A different world…

- In the years before 2008, the advisory lens was focused on following markets and the investment process.

- Post 2008, additional variables are playing a larger role in the advisory process.

The advisory ecosystem is increasingly complex
Part 1 - MARKET DYNAMICS
Market cycles have shortened

- Higher volatility
- Higher correlation
- Shorter cycles

Policy uncertainty has led to significant market volatility, higher correlation and has created much uncertainty.
- Unorthodox central bank policy
- Market riot – policy response cycle
- Regulation changes

Markets have been responsive to short-term economic surprises

Source: Bloomberg

Markets focusing on short term due to higher uncertainty
A more volatile & correlated environment

Cross-asset returns correlation has gone up since mid-2008

- Since 2008
  - Equity market volatility has gone up
  - Credit market volatility has gone down
  - Correlation across asset classes has gone up
- Rise in uncertainty a key reason for structurally higher volatility
- Crisis-market riot-policy response cycle has led to spikes in volatility
- Lower importance of asset class fundamental factors

Higher uncertainty has raised market volatility and cross-asset correlation

Source: Bloomberg
Financial markets have broadened & deepened

- Europe is fragmenting
- East is broadening and deepening
- Economic growth has raised demand for capital
- Financial markets outside the developed world have deepened in response
- Investors therefore have more investment alternatives outside of equities alone
- This has made greater diversification of investor portfolios possible
- Asian corporate credit markets have deepened & broadened
- Asian FX markets have deepened in response to rising trade
- Asian equity markets display better sector diversification
- Greater ETF availability for regional assets
- Inflation-linked securities increasingly available

Broadening & deepening of EM financial markets underway

Source: BIS
Banks

Structured Credit

Private Capital

Others?

Need for funding (medium to high risk capital)

Investable Money

- Banking systems across the globe are stretched given recent credit crisis and stricter capital requirements
- Post 2008, the structured credit market has dried up
- Private capital is a source of funding but may not be able to meet the entire funding need; also limited to a certain pool of investors
- Is there a role for the retail investor in addressing this funding gap? Level of due-diligence and regulation are impediments to the small investor entering this market

Can the retail investor help address the funding gap?
A strategy for current markets

• Post 2008, policy intervention and political uncertainty have pushed markets into “risk-on”/”risk-off” cycles

• An option to tackle this environment is implementing a barbell portfolio strategy combining market beta from risk-on and risk-off assets

• An alternative is to partially immunize the portfolio by investing in assets that are less affected by the risk-on/risk-off cycle i.e. neutral beta.

• A refined version is to adopt a form of immunization approach with the option to tactically add risk-off and risk-on exposure.

• One could partially immunize the portfolio with assets to shorten portfolio duration i.e. dividend yielding equity and high yield bonds.

• Example of tactical positions include CTAs/Volatility funds (Risk Off option) and US Equity/Oil (Risk On option)
Innovation: Portfolio & Product Construction

EDHEC Survey on Portfolio Construction

“Do you agree that the industry has to make progress on integrating state-of-the-art portfolio optimization techniques?”

Key Ideas

- ‘Old paradigm’ portfolio construction techniques being revisited; innovation on the rise again
- Given elevated market volatility, a host of new techniques being proposed – risk parity, alternative beta, equal-weight portfolios, maximum diversification
- On the product side, a clear need for niche sources of return. For example, underexplored sectors in Europe vs. broad based European exposure.
- However, innovation challenged by investor sentiment and regulatory developments
- Key question – is there appetite from regulators and in the retail investor space for such innovation?

Part 2 -
OTHER FACTORS
Impact of regulation

1. **Client Suitability**
   - Post 2008, major focus on client suitability
   - Suitability on three levels
     - Portfolio risk
     - Product risk
     - Knowledge & Experience

2. **Portfolio Advice**
   - Multiple models of portfolio advice based on regulation
   - Guidance varies depending on country regulator
   - Universal portfolio model not applicable in Asia

3. **Internal Process**
   - Governance function playing an increasingly important role in advisory function
   - Back-office costs, typically stemming from IT and compliance, constitute 45% of the total cost base (2011 Mckinsey survey)

Regulation – a key factor in nature of advice delivered
New Developments in Behavioral Finance


Individuals in the West think that
- World is comprised of discrete objects belonging to categories (Greek philosophy)
- Rule-based approach, formal logic help explain and predict behaviors
- Environment is organized
- Life is highly subject to personal control
- Contradiction lead to polarization of belief

Asians think that
- Holistic approach to a world that is full of context
- Relatively little use of categories and formal logic
- Importance of change, contradictions and multiple perspectives
- Search for the middle way
- Environment is chaotic
- Life is subject to changes of fortune without notice
- Contradiction lead to moderation of belief

Source: Yang Liu, “East meets West” (2007)

Behavioral finance theory generally oriented towards the Western mindset – what about Asian behavioral finance?
Building TRUST

HNW Client Trust Levels (2008-2010)


Trust in firms and advisors increasing over time
Concluding thoughts

- High correlation, bouts of volatility remain a reality
- Innovation needed but key players skepticism need to be overcome
- Solutions should be theoretically sound while addressing investor biases
- Challenges & opportunities go beyond macro-finance uncertainties
- Trust is being rebuilt

Thank You