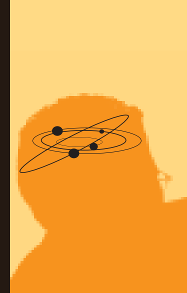
JUNE 2003 ISSUE 11

PWM

PROFESSIONAL WEALTH MANAGEMENT
SOLUTIONS FOR EUROPEAN DISTRIBUTORS



INTRODUCTION

HEALTH CHECK FOR MARKET STRATEGIES

Asset allocation strategies must account for trends, not just past performance

For many investors, reviewing their portfolio's asset allocation is like going for an annual health check. They know it's the right thing to do, yet it is time consuming and potentially disruptive; as long as there are no outward symptoms, it often gets put off.

During much of the 1990s, many stock market investors believed they had healthy portfolios. The global equity downturn prompted them to take a second look. Many surprised investors found in asset allocation a sophisticated tool for improving positive performance.

Asset allocation strategies can now take better account of the investments a portfolio may hold – from "core" asset classes like cash, bonds and stocks to alternative or "satellite" investments like hedge funds, private equity and real estate.

Asset allocation refers to a deliberate decision by an investor to apportion a portfolio's capital among different categories of investments. Investors do this to take advantage of a broader range of opportunities to improve return potential. They also expect the different categories will perform differently. Over time this can even out overall portfolio volatility.

RISK TOLERANCE

The allocation decision is inextricably linked to the task of managing private wealth. Key considerations are the client's overall wealth and tax situation as well as currency and level of anticipated cash flows. As these things change, allocation decisions may also need to change.

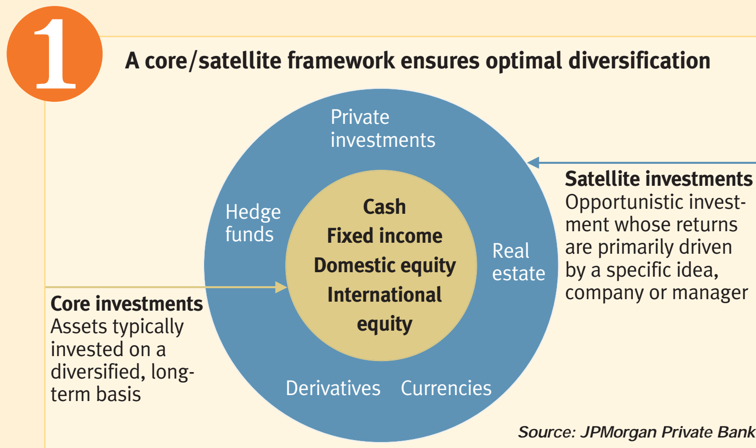
Traditionally, financial firms would base allocations on clients' risk tolerance. "Conservative" investors were steered into bonds and "aggressive" ones into equities.

This approach has its limitations. The traditional measure of risk is volatility, measured by standard deviation of returns. But wealthy individuals speak about risk in terms of losing money, or not having enough to meet goals, rather than in standard deviation terms. Also, looking at risk tolerance in isolation – without taking into account life circumstances, business interests, and estate planning goals – can be misleading.

'Many surprised investors found in asset allocation a sophisticated tool for improving positive performance'
Lex Zaharoff, JPMorgan Private Bank

Investors whose business involves risking large amounts of their own capital may seek a conservative allocation for their investment portfolio – even though a standard appraisal defines them as "risk takers". A retired couple with a conservative investment history might be advised to consider a more aggressive strategy for the portion of wealth targeted for heirs.

Taxpaying investors need to consider asset allocation in an after-tax framework. The allocation itself should have tax status in mind, with proper weight given to tax-advantaged securities. Once the decision has been made,



Source: JPMorgan Private Bank

the portfolio needs to be managed through tax-aware investment strategies. Too frequent rebalancings to keep a portfolio in line with a predefined allocation can have negative tax consequences, eroding the benefits that allocation is supposed to bring.

SOLID CORE

Which investments should be included in a well-designed allocation? And what is the right mix? Here is where traditional asset allocation has progressed to a new and different level.

Most investors think of asset allocation as a predefined mix of traditional, publicly traded stocks, bonds, and cash. A UK investor might hold a large percentage of equities in UK stocks, followed by US and European equities, and then possibly an allocation to Japan or emerging markets.

Their allocation to bonds generally focuses on investment-grade bonds in home currency, with possible exposure to riskier domestic credits and foreign issues. It is still true that asset allocation assigns a central role to such investments, which represent the "core" of a sound strategy. Core assets should be broadly diversified to fully capture potential diversification benefits of component asset classes individually and of the mix as a whole.

The real crux of the core asset allocation decision continues to be the mix between equities, bonds and cash. There are periods where these assets move together, but ultimately these are different financial instruments with very different risk/return characteristics. Consequently, a well-designed asset allocation strategy can take advantage of market disparities to optimise the portfolio's core holdings.

But what is a "well-designed" core allocation? Many allocations from financial firms are based on analysing historical performance of core assets. A more effective technique is to take into account expected performance. This is critical because investors can take advantage of global economic and market trends that cause the performance of an asset class to diverge from historical norms.

A core allocation "strategy" should never be set in stone, but periodically adjusted at the borders to take advantage of short-term shifts in attractiveness of various classes. And it needs to be reviewed regularly.

Alternative investments offer returns less related to capital markets, sometimes referred to as "absolute-return" driven. They are chosen for their potential to earn exceptional returns or employ techniques to limit downside risks. They tend to have less "capital market risk" and more of the other risks, compared with traditional assets. Examples include private equity, hedge funds, venture capital, initial public offerings (IPOs), foreign exchange, and concentrated "baskets" of publicly traded stocks designed to capitalise on particular investment themes. Some of these other risks are lack of liquidity, event risk, manager selection or information risk.

Incorporating alternatives is not just about adding hedge funds to capture outsized returns. It's about adding the right combination of hedge funds and other alternatives that not only complement each other, but also complement the other strategies embedded within the portfolio. Because of the different types of risks, alternatives require more supervision. Private equity heavily depends on the skill of particular managers. Analyses have shown greater performance divergence between best and worst managers of private equity and hedge funds than traditional investments. The "information risk" can be critical. There is survivorship bias in the performance data, and infrequent valuations may understate risks; the investments are not transparent – there is a large trust factor.

At the end of the 1990s, many asked themselves and their advisers why they should invest in bonds. Recently that question was re-phrased as "why should I invest in stocks?" Each time there is a small rally in stock markets, the question becomes, "is now the time to invest my cash?" The answer is an asset allocation strategy designed to maximise the likelihood of meeting goals within the context of overall wealth, tax situation, anticipated cash flows and risk preference.

Lex Zaharoff, Advice Lab, JPMorgan Private Bank

CORPORATE STATEMENT

JPMorgan Private Bank is a global financial leader providing advice and customised solutions to wealthy individuals and their families. Using broad capabilities in investing, tax and estate planning, family office management, philanthropy and credit, JPMorgan Private Bank helps clients meet their goals. A comprehensive, integrated approach, a commitment to innovation and integrity and focus on client service have made JPMorgan Private Bank an adviser of choice to those of significant wealth around the world.

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