

Private wealth management needs better risk control

[Print](#)

By Noël Amenc and Felix Goltz

Published: December 13 2009 10:06 | Last updated: December 13 2009 10:06

What is wrong with the traditional approach to private **wealth management**?

Managing the assets of wealthy individuals has always been one of the main businesses of banks. Currently there are close to 9m individuals worldwide who have investable wealth in excess of \$1m.

The main advantage private wealth managers offer these clients is to come up with customised solutions that take into account the client's specific needs.

Unlike retail clients, these individuals can expect their adviser to take their personal situation and preferences into consideration when defining investment strategy. And private wealth managers see customisation as their primary source of added value.

However, in current practice, customisation mainly takes the form of tax advice.

In investment risk management, customisation all too often stops at the client's overall level of risk aversion, without specific consideration of his or her particular situation. Depending on the client's risk appetite, the portfolio will be invested in more or less risky assets.

Like mutual fund managers, private wealth managers focus on managing the risk in terms of overall fluctuations of wealth (absolute risk) or in terms of the deviations of portfolio returns from a benchmark such as a widely-followed market index (relative risk).

Such generic risk measures may not correspond to the client's risk preferences at all. The question of what risk matters to a client is in fact a very personal one. In particular, risk depends on the objectives the client has for his wealth, as well as the unique financial situation of the client.

An important factor that wealth managers have to take into account is the client's spending objectives. While overall inflation is of obvious importance, wealthy individuals should expect advisers to take the personal purchasing power of their wealth into account, as opposed to the generic inflation rate.

For example, a wealthy individual who wants to spend savings on building up a collection of Japanese art may face a different inflation rate from another individual who plans to use wealth to purchase a penthouse in Manhattan.

More generally, the risk faced by the client will depend on the type of assets, the currency and the region of his future expenditure.

The time horizon for these spending objectives will also have an impact on the appropriate investment strategy. Another factor that matters is the income from outside the client's managed wealth portfolio.

For example, if the client is an IT entrepreneur, he may be more reluctant than the average investor to take on exposure to stocks in this sector.

Wealth management practices do not address such specific concerns over risk management, because advisers lack the appropriate tools and concepts. In a survey by Edhec-Risk Institute, only 16 per cent of wealth managers were satisfied with the risk management tools they have at their disposal. A mere 7 per cent were happy with the way they control their clients' exposure to risks.

A possible remedy to this situation may be to look at the world of institutional investment management.

Large pension funds face similar investment problems when looking at the concept of spending objectives. The spending objective of pension funds is to be able to provide defined pension benefits to employees when they retire. Pension funds make wide use of sophisticated asset liability management tools that manage risk relative to these spending objectives.

Edhec-Risk Institute is researching such concepts with the support of Ortec Finance. This research has shown that taking into account the spending objectives of individuals leads to two important changes in portfolio management.

First, investors will tend to favour asset classes that provide some form of protection against increases in future spending, notably real assets such as real estate and commodities.

Second, the focus switches from the value of the assets only (or the wealth in dollars), to the degree to which objectives can be fulfilled.

Using such institutional techniques in private wealth management is considered to be a promising concept to strengthen advisory quality in private wealth management by 86 per cent of European wealth managers.

Still, practitioners worry about a lack of expertise within private wealth management teams when it comes to implementing this technology. Further convergence of the concepts used in institutional wealth management and private wealth management may require time and effort, but disappointment over losses following the financial crisis and more demanding clients will play their part in establishing more sophisticated risk management.

After all, how are private wealth managers going to explain to their most wealthy clients that they receive less sophisticated risk management than public sector pensioners?

Noël Amenc is director of Edhec-Risk Institute; Felix Goltz is head of applied research

Copyright The Financial Times Limited 2009. Print a single copy of this article for personal use. [Contact us](#) if you wish to print more to distribute to others.

"FT" and "Financial Times" are trademarks of the Financial Times. [Privacy policy](#) | [Terms](#)
© Copyright [The Financial Times](#) Ltd 2009.