Beyond COVID-19 — opportunities for wealth managers

A decade that was relatively kind to investors has come to an abrupt end. With fear stalking the markets, investors need help managing their wealth more than ever.

Wealth managers will need to navigate an unfamiliar economic backdrop, with interest rates being cut below even the levels during the financial crisis, unprecedented government support to keep businesses mothballed, and the potential for social tension and mass unemployment. The world has changed, and wealth managers need to adapt quickly. Those wealth managers that have taken steps to prepare for this change will thrive, but many will not.

01/

Governance and oversight in the spotlight

Failures of governance featured prominently in the fund industry in 2019, highlighted by the implosion of Woodford Investment Management following the gating of its flagship fund. More recently, property funds have been gated and liquidity is under pressure in other asset classes. Dispersion of fund returns has exploded and many funds have not performed as expected. We expect regulatory bodies to focus even more closely on due diligence, governance and oversight of regulated funds. We think the key areas of focus should be:

- Due diligence and fund oversight. Many problem funds have featured on prominent fund buy lists, and are held in both discretionary and advisory client accounts. All firms will need to ensure that pre-investment and ongoing due diligence processes are fit for purpose, and they will also need to identify all fund risks. It will no longer be enough to rely on manager reputations when it comes to assessing fund risks.
- Liquidity of fund holdings. Investing in less liquid asset classes, such as real estate, when they provide a premium for this illiquidity is entirely logical in our view. However, we question whether daily dealing funds are suitable vehicles when the assets cannot be quickly or easily sold to meet redemptions. The extent to which daily dealing vehicles can be used is likely to come under greater regulatory scrutiny. In the meantime, we anticipate that investors and their advisors will favour allocations with good liquidity characteristics, such as real estate investment trusts (REITs). The COVID-19 crisis has served to demonstrate that liquidity can dry up very quickly in apparently liquid categories. Dealing costs and spreads have ballooned for some asset classes such as high yield fixed income. Wealth managers need to ensure that their due diligence includes an assessment of all the risks that could impact a fund, including the liquidity profile of its holdings.
- Portfolio diversification. As the market sold off all asset classes, even those perceived as a safe haven, such as gold, have seen negative returns. Clients will question whether portfolios have been effectively diversified. For those portfolios that are designed to keep within a risk band, many will have struggled to maintain risk as promised. With the outlook for the global economy and markets impossible to forecast with ongoing lockdowns, clients are looking to their wealth managers to provide a path back to growth.

02/

ESG (environmental, social and governance) integration comes of age

Mirroring real-world concerns such as climate change, ESG-oriented funds have exploded onto the wider European fund landscape in recent years. With more than 2,000 sustainable funds now listed in Europe, investors have a dizzying array of options when looking to invest more responsibly. The universe of funds is now filled with industry jargon — "ethical", "impact", "sustainable" — and the challenge for investors is dissecting and distinguishing the options to identify those funds that can specifically meet their objectives. We expect demand for ESG-specific solutions to accelerate as investors (both institutional and retail) become more comfortable with the terminology and evidence emerges of the enhanced financial performance of those companies that demonstrate greater ESG integration. Indeed, growing evidence of ESG funds outperforming mainstream funds during the COVID-19 crisis is likely to attract further investor interest. A rapidly evolving and associated challenge for fund managers will be to clearly demonstrate how they are integrating ESG concepts into mainstream funds.

Moreover, another watchpoint for all fund selectors is that there will be no shortage of both real and perceived "greenwashing", so expect a backlash against some funds that do not live up to the expectations they set as well as against the failure of voluntary codes, such as UN PRI, to facilitate real change.

03/

Fee pressure adds to fund management woes

Triggered by regulation, especially MiFID II and the retail distribution review (RDR) in the UK, there is much greater transparency of fees and clients are more aware of what they are paying. With clients sitting on losses and interest rates likely to remain very low for the foreseeable future, we expect clients to look to reduce the fees burden. In particular, income-oriented clients in drawdown are likely to be increasingly concerned about the impact of fees and income being paid out of their capital, crystallising losses. Platforms, wealth managers and fund manufacturers all face growing competition from the combined forces of new entrants, automated solutions and the relentless rise of indexers/ETFs. In our view, the firms most at risk are mainstream, benchmark-sensitive active fund managers, who will come under increased pressure from fund buyers and selectors to reduce fees. With passive fees now in single-digit basis points for core asset classes, and the disappointing returns delivered by some of the most celebrated active managers, only those funds that compete on quality and cost are likely to succeed.

04/

Reports of the death of active funds are greatly exaggerated

The popularity of active funds has been in decline for a number of years, as investors have preferred lower cost passive index tracking funds. However, the relative performance of active and passive investing is cyclical. Passive funds do better in some market environments — for example, when the largest cap stocks outperform. Active managers also tend not to do well in periods when markets are behaving irrationally, but these periods are usually short-lived. The relative outperformance of US mega-cap stocks such as Amazon, Apple and Netflix in recent years has benefited passive funds, but investors should be careful not to discount a shift at some point back toward more value-oriented, smaller cap names. It is also important to note that not all active funds are created equal, and there is empirical evidence to support funds that combine high active share with low turnover. We would encourage investors to focus their attention on these characteristics when selecting active funds.

05/

Rebalancing in troubled markets

In normal markets, rebalancing is a sensible risk control measure, which can also potentially enhance returns. Rebalancing a client portfolio ensures it remains consistent with the client's risk profile and its benchmark. But after a major market sell-off, rebalancing can result in selling a significant portion of the client's more defensive fixed income or cash allocation and buying equities. At times of heightened volatility, this comes with costs — dealing spreads have multiplied in recent weeks by three to four times in many cases. If equities continue to fall, then clients may question the wisdom of reallocating to this asset class. While those clients with an ample risk appetite may want to double down as markets fall to maximise upside in a recovery, other clients, especially those in drawdown or with shorter time horizons, may prefer to stick with the allocation they have. In practice, a client's appetite for risk may change depending on the market backdrop. Clients often become more risk averse in bear markets so allowing a higher allocation to defensive assets to build up naturally may be the right approach for some clients. Wealth managers need to consider whether automatically rebalancing is in each client's best interest.

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*As at 30 June 2019.

**As at 30 November 2019.

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