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The Voice of the Investment Management Consultant

Institutional Practices for the High Net Worth Client

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For many years, institutions have followed a very disciplined and orderly investment process. Increasingly over the last decade, these ideas and the growing importance of a well-defined process have been codified at the state level – namely in the Uniform Prudent Investors Act (1994), the Uniform Principal and Income Act (1997) and most recently, the Uniform Trust Code (2000). Varying in impact on the decision-making process, these uniform laws have made "official" those things held in esteem at the institutional level for some time. This, of course, is to say nothing of the Employee Retirement Income Security Act (ERISA) and the mountain of case law that continues to follow.

With the impact of technology and the evolving business practices that each of us planners have adopted over the years, it is quite logical to ask whether it makes sense to begin to move these "institutional" investment practices to the individual high-net-worth marketplace. Our contention is that this migration of business practices and disciplines is inevitable. Our goal in this article is to communicate those practices and characteristics that will help you not only stay ahead of the curve, but to thrive in this increasingly competitive arena.

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Discovery

Using the CFP Board of Standard's "Financial Planning Process" as a template for our discussion, we know that Steps One and Two deal with the idea (and **responsibility**) of knowing our clients. In keeping with that need, the first two steps comprise the discovery stage. Specifically, Step Two is defined as "gathering client data including goals." This information is of vital importance; no advice or service worth the effort can be provided without a clear understanding of the client's current situation, as well as other key characteristics (cash flow, risk tolerance, etc).

When dealing with institutional clients, it is always safer to assume that they are fiduciaries by the very nature of their positions and their relationship with the organization. In keeping with that, it is prudent to ensure that we, as wealth management professionals, go beyond what is suggested by Steps One and Two of the CFP process.

We would suggest that a thorough review of all trust and/or plan documents be undertaken. Additionally, we would spend time discussing those trust circumstances where separate principal and income beneficiaries exist. With trust law continuing to evolve, support for Unitrust treatment is continuing to grow. And speaking of "external" influences – in this case legal ones – UPIA specifically states that other "outside" factors must also be considered. General economic conditions, the effects of inflation/deflation, expected return and tax consequences, among others, are specifically mentioned as worthy of consideration by the Act. Information on these external dynamics must also be gathered and fit neatly into the discovery phase of the process. Coincidentally, this process also affords the opportunity to discuss the very real responsibilities of being a fiduciary with the client.

Investment Policy Statements

Once the discovery has evolved (because that stage is never really complete, is it?), it is important to systematically document what, to this point, has been just

verbally communication. We continue to be amazed at how this additional step really sets our practice apart. The clients we see very much enjoy that we take the time to write down what they want, record mutually agreed upon realistic expectations and list the responsibilities of each individual party – client included.

Using an Investment Policy Statement (IPS) is more than just a nicety to institutions, it's a requirement. We submit that although an IPS is not technically required for the individual, the use of one leads to a more satisfactory relationship and arguably better overall investment results. We've all seen the studies that show how the results of the average investor are less than the results of the funds in which they actually invested. Removal of the elements that tend to detract from performance will, by definition, tend to improve it.

Quality Investment Policy Statements have a number of key components. A very short list of the "gotta haves" include:

- Statement of Purpose
- Investment Objectives, Goals
- Investment Guidelines
- Control Procedures
- Statement of Responsibilities
- Manager Review and Evaluation

An IPS does not have to be long to be useful. Flexibility and ease of use are paramount; it is not intended to be a static document. It is perhaps one of the easiest, and from the client's perspective, one of the most welcome, steps to add in your current investment process.

Asset Allocation

As the last few years have reminded us all, an important benefit provided by diversification is that of risk/volatility reduction. Interestingly enough, it also, from time to time, increases returns. When talking with clients about diversification in the 90s, it always felt – and we're sure sounded – a little boring. Why be diversified when all one needs is a basket of tech stocks (or in too many cases, five different small cap growth funds)? With the now available benefit of hindsight, simply being diversified can, in those times we need it most, potentially add to returns.

STYLE PURITY, RISK ADJUSTED RETURNS, PERSONNEL TURNOVER, LENGTH OF MANAGER TENURE, AS WELL AS OTHER CHARACTERISTICS, ARE INTRODUCED AT THE INSTITUTIONAL LEVEL AND WOULD BE WELCOMED ADDITIONS TO THE HIGH NET WORTH MARKETPLACE

Institutions have long had a very real sensitivity to volatility – especially as it relates to their spending and/or funding requirements. An important practice to implement is periodic rebalancing. Remember that diversification works as long as the portfolio in question is, in fact, diversified. It often takes Herculean strength to do what is "right" in the face of contrary market momentum. Documenting the criteria that will be used to trigger portfolio rebalancing can be of great benefit in helping to offset the "emotional inputs" that may arise.

Asset allocation modeling has taken on a renewed importance in these volatile markets. In keeping with quality output, a prudent practitioner must ensure that the mean variance optimizer (MVO) resource being used is not only taking in enough market experience to be of use, but also utilizes appropriate expected return and volatility assumptions. While there are a good many credentials that would help in the process, sometimes a good, old-fashioned smell test works just fine. We recently reviewed a program that used only the last five years of market experience as input. Needless to say, the allocation recommended was not practical.

Lastly, on the topic of asset allocation, institutions are increasingly interested in probability analysis. How probable is any given outcome given a set of inputs? High net worth clients are also keenly interested in knowing whether or not their asset or income goals can be reached within an expected timeframe. In our experience, the excitement and changes being brought about by probability-style analysis, such as Monte Carlo, is warranted. If you haven't done so already, learn more about this very powerful tool.

Due Diligence

Having an institutional orientation towards your high net worth clients often means more structure and documentation than many of us are traditionally used to. In no stage in the process is this clearer than in what has been called Stage Four by the CFP Board of Standards: "developing and presenting … recommendations and/or alternatives." Applying a rigorous process to the selection of potential managers or funds no longer allows for the occasional shortcut of using those "favorite" funds.

A good IPS will also include language which states criteria for investment selections as well as a listing of prohibited investments. Fiduciaries are benefited from documenting their search and selection criteria as well – making the work that we do more valuable.

It takes much more than performance to make an investment vehicle attractive. Style purity, risk adjusted returns, personnel turnover, length of manager tenure, as well as other characteristics, are introduced at the institutional level and would be welcomed additions to the high net worth marketplace. It should be little surprise that this selection (and retention) process adds to the client's comfort as well as to their total return. Keeping the portfolio safe from ad hoc fund and manager selection will benefit the account's growth and provide continuity over time.

Don't be surprised if these additional search and selection criteria require upgrades in technology and software. We have found that these investments in infrastructure have more than paid for themselves, taking the sting out of the upfront outlay.

Implementation

Step Five of the CFP process is "Implementation," but before the actual implementation occurs, some thought has to be given to the "best" implementation vehicle. In fact, "best" should be defined by the objectives and characteristics of the client. In keeping with that priority, effort must be spent to ensure that the dynamics of whatever types of investments are decided upon are appropriate. This might mean moving increasingly to customization.

All things being equal, some clients simply do better with a portfolio of funds as opposed to hiring managers directly (through "wrap" programs). Having already addressed suitability issues, it might sometimes make sense for clients to incrementally pay a little more but be comfortable with their end investment choices. Similarly, not all clients see the world the same. Some view it as a question of cost, some of net performance. By incorporating the client's perspective, the implementation solution will ultimately lead to higher client satisfaction.

It is important to remember that after the investments have been chosen to fulfill the optimal portfolio allocation, the process is far from complete. On-going due diligence and communication is necessary to ensure that the IPS, asset allocation and investment choices remain appropriate. We have intentionally not addressed performance monitoring and reporting due to space restraints.

Fringe Benefits

In this increasingly litigious environment, the benefit of a disciplined process should be self-evident. The fiduciary considerations of which high net worth investors have become increasingly aware must play a role in how planners interact with their clients.

Having a process does not equate to being inflexible – in fact, far from it. It is the process that is predictable, not necessarily the outcome. The process has a way of even providing comfort – especially as the process does not have a defined ending point. Should something require change (i.e., an underperforming fund or manager), the discovery process begins anew.

The benefit of having this process is not exclusively the client's. By utilizing a definable process, we unexpectedly found that we actually feel better about what we do professionally. That confidence and sense of value comes across in our interactions. Pricing, client loyalty and quality of life were all positively impacted by our using more advanced practices with our clients.

Food for Thought ...

As these changes are incorporated into your practice over time, it is likely that other accepted policies or past decisions are revisited. The industry continues to divide itself over the subject of compensation, namely fees vs. commissions. While it is outside the scope of this article to give you our thoughts, either pro or con, it's our suspicion that the way you frame that discussion and its impact on your practice could change. This might also hold true for the subject of teams. Bringing a higher caliber of service and on-going communication might force positive changes to your infrastructure to help deliver these priorities. Lastly, does it make sense to enact or enforce account minimums? And if so, how?

We hope that we have begun to introduce a good number of the practices long held to be standard for the institutional client. We submit that they have been long-standing for a reason. Bringing these "up market" practices to individual high net worth clients not only adds discipline to the investment management process, but it also increases client satisfaction and account longevity – both contributing to quality of life for clients and their advisors as well. ■

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