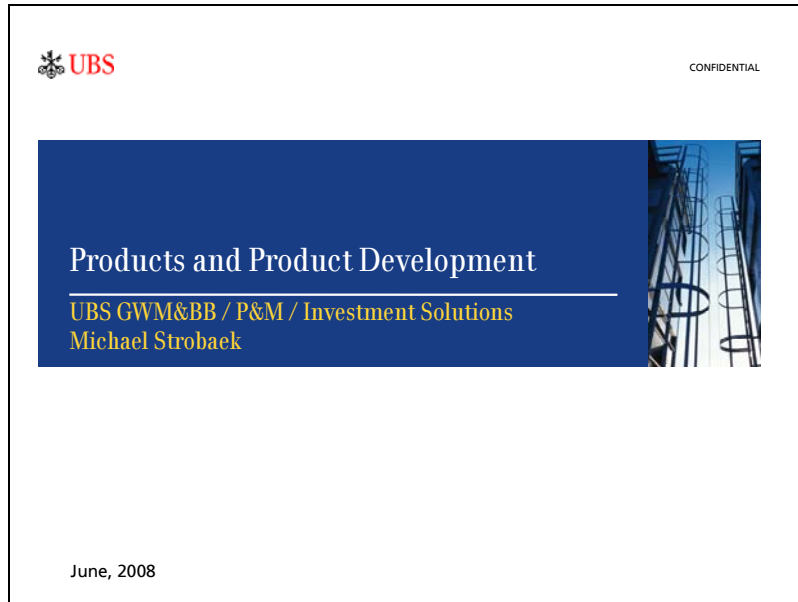
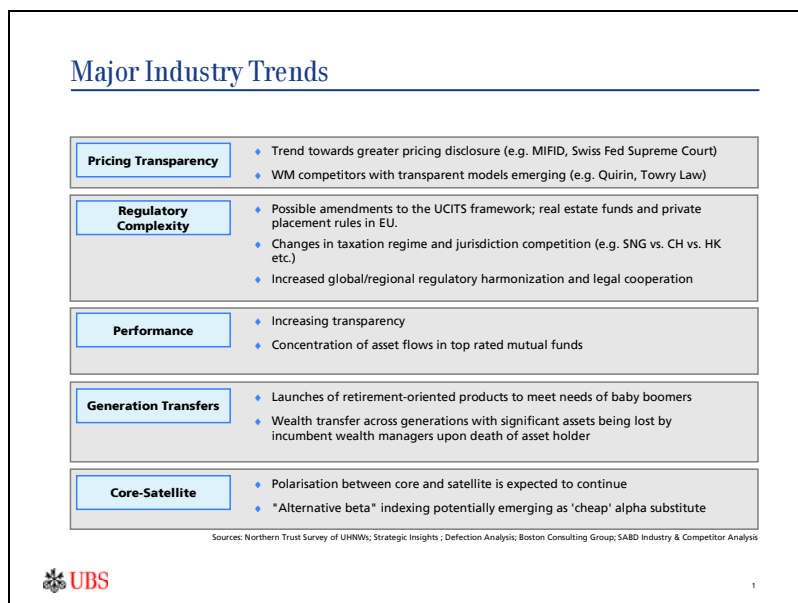


Michael Strobaek



I will highlight a few themes that are affecting how we develop products for private clients in UBS Global Wealth Management. Our Investment Solutions unit focuses on developing discretionary portfolio solutions and alternative investment solutions for private clients.

There are five main themes that guide us in everything we do. When I now run through them, you will find that they are similar – on a high level – to what you just heard on the institutional side. However, the angles from which they are viewed are very different.



Pricing transparency is one of the major trends in the private client business. MiFID has a profound impact on many institutions in Europe. The demand coming from regulators and from the private clients themselves to understand what they ultimately pay for their investment solutions is becoming more and more important. The regulators also want to make sure that we as wealth managers do not become

entangled in conflicts of interest with our investment decisions. They want to make sure that we are driven by client interest, not by our own economic considerations. That is a major driver and it affects the way we develop products and solutions.

The complexity of the regulatory environment is also increasing. It is, in my view, an illusion to think that regulation per se – especially given the divergence of regulation between markets – makes it easier for the market players to operate. The opposite is true. The density and complexity of regulation makes our life increasingly complicated. The same is true for the area of taxation.

It is not a coincidence that performance is shown at the core position of my list. Obviously, clients are interested in their performance at the end of the day. In the case of an institutional client, the meaning of "performance" is very clear. But for a private client, performance has many different aspects. It can mean satisfaction with the bank, it can mean doing better than a reference benchmark, or it can mean the ability to sleep well, trusting that his money is in good hands. In the private wealth management segment, no two clients probably have the same definition for what satisfactory performance means, apart from the fact that all private clients hate losing money.

There is a certain symmetry in the way the institutional and the private client worlds operate. In the private client world however, the current turbulent market environment is a reminder that most clients tend not to understand the potential risks that may be embedded in the investment solutions offered to them. They only come to understand them after problems have occurred. Paradoxically, low risk solutions have turned out to be high risk solutions. Every client who had a cash-enhanced product that was somehow exposed to the sub-prime market, found himself in an increasingly risky situation. On the other hand, equity products which are supposedly the high risk products generally did not have a problem at all during the same period.

Generation transfers is an ongoing topic. It is rather difficult to say how it affects product development at this stage. But we experience that private clients do not yet sufficiently understand the concepts of dynamic asset allocation or life cycle solutions.

Core-satellite solutions: This is a mega trend, taken over from the institutional investment world. It is slowly arriving in the private wealth management scene, at this time mainly in the Ultra High Net Worth Individual segment. The slow arrival has to do with economics, but also with the private clients in general. They do not fully understand the concept yet and what it may mean to them.

We are right now at a kind of breaking point with regard to portfolio solutions development in some areas. We face a massive challenge with the so-called "absolute return" labeled products that offer a "LIBOR plus" or similar performance target. In almost any market environment, it is pretty obvious that there is no free lunch. There is no product that provides a profit without any risk at all. Many private clients did not realize that. The current market environment has once again reminded us that most clients want products which offer an overall attractive risk/return reward, coupled with a certain level of stability. Such products are not only attractive for the client; they are also good for the client's relationship with his bank. We are now moving towards new solutions taking this key aspect into consideration.

The core-satellite approach is slowly gaining ground with sophisticated Ultra High Net Worth individuals, family offices, and also with clients who are extremely price-averse. In the private wealth management area, the only way that you can get close to the pricing levels those clients demand, is by replacing some of the traditional wealth management instruments. The prime target that will be hit is the typical retail investment fund. Retail funds ended up in client portfolio solutions for good reasons. They provided diversification and exposure. Now they are becoming increasingly untenable because of their fee load.

The second element is the active versus passive management debate, meaning whether core asset managers actually add any value or not. My view is that there are managers that do provide value, but they are rare, and you need to look carefully for them. Private clients are however not much interested in discussing fully passive management solutions.

The main challenges in our market environment are again summarized in the slide below.

Challenging Market Environment

- ◆ Subprime crises causes reduced trust and confidence in private banks (e.g. low risk / cash like products turn out to be high risk / losing money)
- ◆ Crises fosters a flight to quality and transparency. Accelerating the speed of changes requested by the regulator (e.g. MiFID). Clients have more concerns and more questions.
- ◆ Increased pressure on product design / pricing: Need to develop simpler to explain product with a clear value proposition for the client

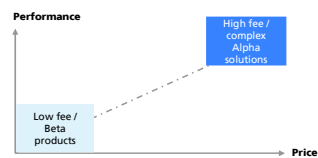


2

UBS Investment Solutions Response

Key to success: manage between "Money is emotional" – client side ...

- ◆ Divergence of active / passive → clear either / or strategies are key
 - Low fee Beta
 - Highly priced Alpha

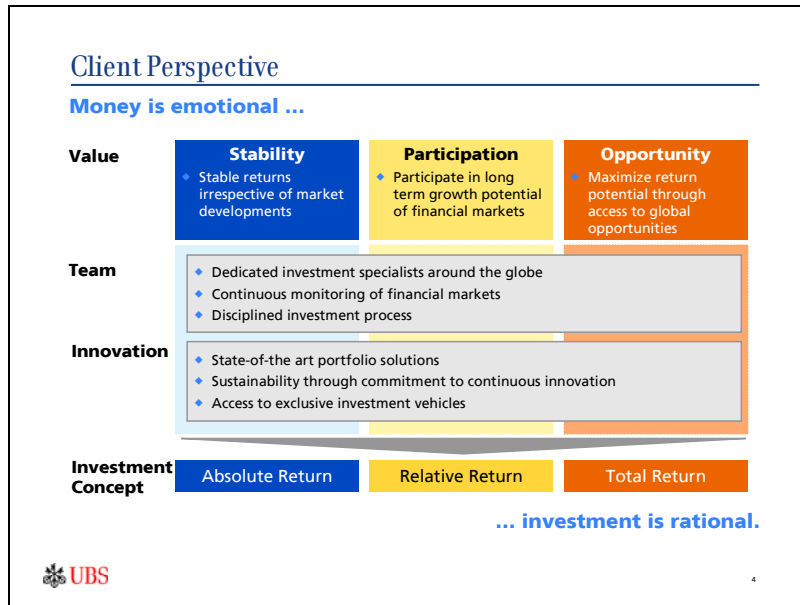


- ◆ Need for stronger support of sales people in light of value shift from processes and products to distribution
 - ◆ Education of sales people and clients
- ... "Investment is rational" – investment management side.**



3

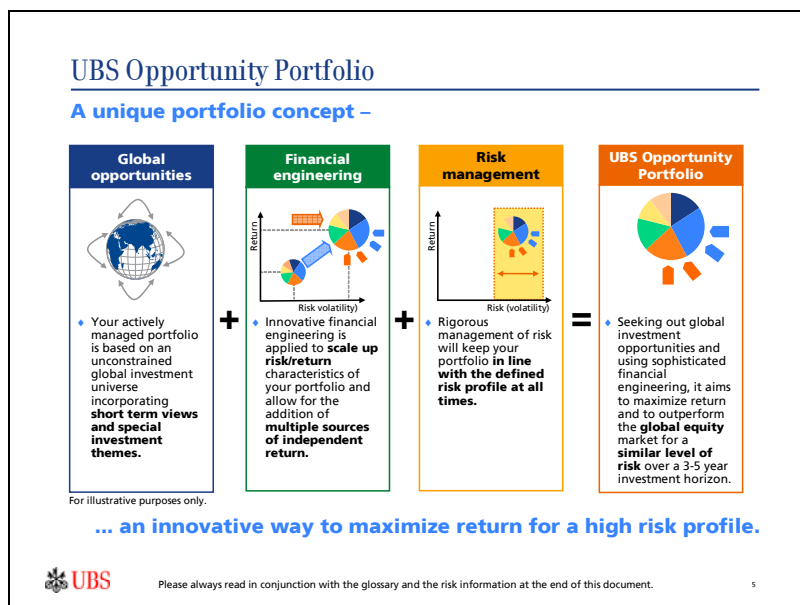
An institutional investor is looking for a rational solution that either outperforms a defined benchmark, or meets a set return target. A private client's approach towards his portfolio is mainly emotional. That is why we have stopped talking about very product-labeled solutions and using technical terms. We have started talking about emotional themes that meet private clients' needs.



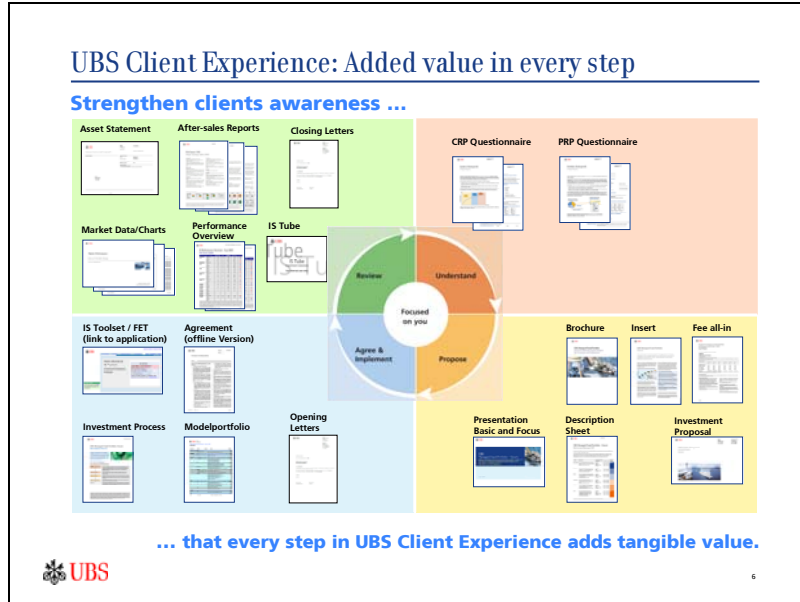
We talk about Stability (meaning absolute return-type solutions), Participation (meaning participation in the financial market development) and Opportunity (meaning an opportunistic approach in finding investment opportunities globally). That is something a private client is receptive to. If you talk about 60% global equity, 40% Euro zone equity, 70% Eurobonds and 30% global bonds and this being the portfolio benchmark, most clients do not know what you are talking about and they understand even less the underlying drivers of their portfolio construction.

We started to describe, from a client's perception, what a certain portfolio solution is meant to do. We now offer those three main pillars, and the opportunity to bundle them. A client can choose to have 80% of his portfolio in Stability and 20% in Opportunity. This is something a private client can relate to and feel comfortable with.

The institutional benchmark orientation was copied over to the private wealth management world because it is an easy way to structure a portfolio. But it is not what the private client expects. The client does not want to hear about adjusting equity portions from 50% to 45% or 55%. That adds nothing to his client experience. He simply wants to hear from his adviser that *steps* are being taken. We know that an asset manager's decision is wrong about 50% of the time. If he is right 55% of the time, the client will appreciate that. But there is a huge risk to the asset manager in a benchmark-based set-up. So we wanted to get away from that benchmark discussion and from downside-managed solutions.



We have developed solutions that are, in a way, more opportunistic. We take advantage of the fact that UBS is a global company, with global representation and global teams. We can access that universe and all its expertise. Financial engineering is becoming more and more sophisticated. We can make more use of those instruments. We can also get a better grip on risk management. That all combines into a total portfolio that is not benchmark oriented, not downside oriented, that is more "all weather-proof" and is appealing to discuss with private clients.



It is vastly underestimated on the private client side what good (or bad) communication means. The easy part is portfolio construction. The hard part is communicating to private clients what they are getting. In this respect, the entire wealth management industry is still in its infancy. The challenge to reach out to clients on a large scale and adequately explain to them what they are getting is huge. Our own Investment Solutions unit serves around 200,000 clients spread across many countries. Many of them we never see or speak to in person. And the default reaction for every client, if he is not satisfied and feels that nobody talks to him, is to drop his product and change the bank.

Communication as happens on the institutional side with quarterly reviews, detailed reporting, performance attribution etc. is about to come into the private wealth management industry as well. But we are not quite there yet.

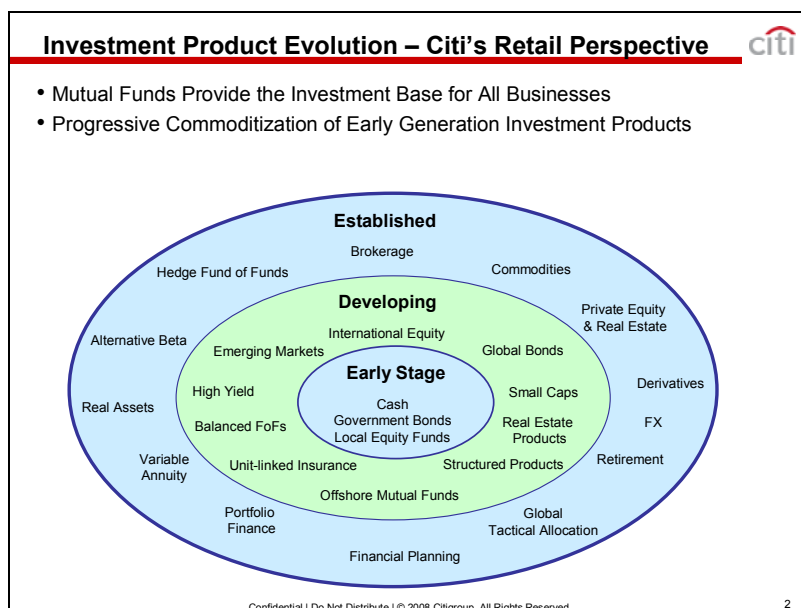
Linda Moore



The extent of change that is currently going on in the industry is staggering, both from a product innovation perspective as well as from a regulatory perspective.

I would like to share with you today what we see is happening within investment products from a retail distributor's perspective, and then describe our current product development process.

The Citi Consumer Bank sells investment products through its branches in 42 markets around the world – from emerging to developed. We target a mass affluent client base, but the definition of "mass affluent" changes depending on the market. Key products include primarily mutual funds, but also brokerage, structured products, which is a fast growing category and a big component in select markets, pensions and annuities, and some alternative investments, which right now for us is a very small but growing asset class.



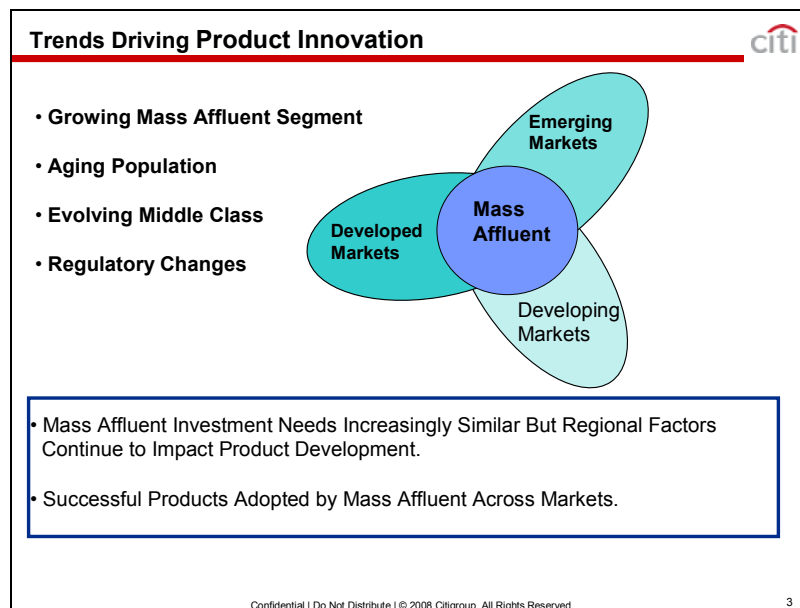
This slide shows our investment products in various markets, grouped by "Early Stage", "Developing" and "Established". In the early stage markets we focus on cash products, bonds, and local equity funds.

In the developing markets (which, according to our criteria, include for example Korea, Spain or Poland) we use a broader product range as those clients are prepared to venture out a little more on the

risk/return spectrum.

In the established markets, there is a wide product universe. The alternative investments come into play here: private equity, hedge fund of funds, derivatives, and the more service oriented products like financial planning and retirement.

This is the model. In reality, we see a progressive commoditization taking place: You no longer need deep financial markets to have demand for sophisticated products. The developing markets are quickly replicating what worked in the established markets, as soon as their regulatory environment enables them to do so.



These are the trends we consider the drivers of product innovation. The number one trend for us is the growing mass affluent client segment. People are wealthier than the previous generations and they want to invest their new wealth. That is a strong driver for our product development.

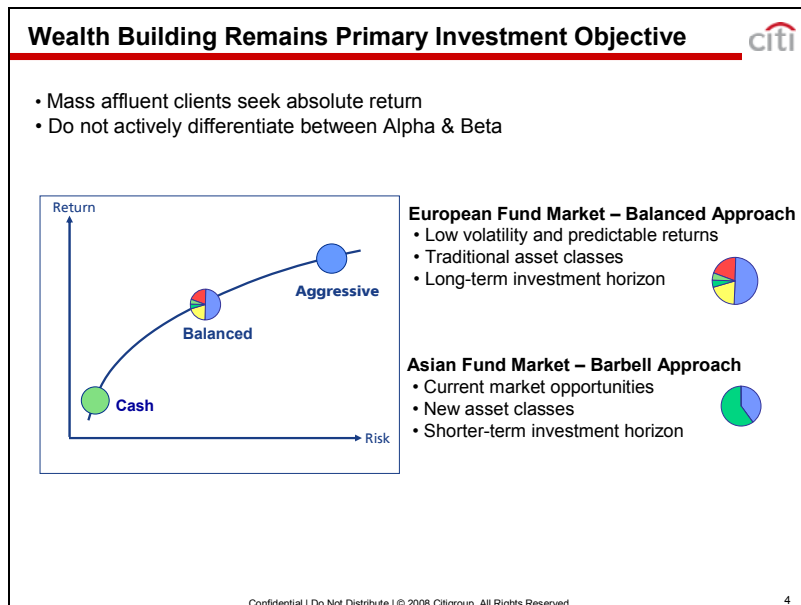
The aging population is also a big theme. Here we focus on the developed markets and on products and services related to retirement.

The evolving middle class is the key trend in the emerging markets. Clients here increasingly have more discretionary income. That creates different personal and business financing needs. Also, those clients are becoming more mobile. This triggered the infrastructure investment theme that we see in many products today.

Regulatory changes: In the developed markets, they tend to put more constraints on product distribution; in the emerging and developing markets, regulatory changes generally open the markets and enable the distribution of new products.

Another big trend is the growing concern about the environment. We see a lot more "green" and socially responsible type of investing than a few years ago.

No matter in what market you are, the needs of the mass affluent client group tend to be the same. Once there is a successful product targeted at mass affluent clients in one market, we quickly see it replicated across all markets.



Wealth building is the mass affluent clients' number one objective. This group does not care for the distinction between Alpha and Beta returns and why you should perhaps consider all factors before using one strategy or the other. All they want is to make the most return possible on their investment.

That being said, the way the clients approach their wealth building, clearly differs by region. In Europe, from our experience, people tend to take a very balanced and rather conservative approach. They want low volatility. They tend to stick to the more traditional asset classes, and they invest with a long term view.

This is very different in Asia. Investors there typically put about 60% of their portfolios into cash or cash-type instruments. The remaining 40% are allocated to high risk products. Asian investors tend to be the first ones to try any new asset class. They like to take new opportunities but they invest only with a short-term horizon. The minute they achieve their envisaged profit, they sell the product and look for something else.

Investment Product Development citi

Key Drivers	Current Product Opportunities	Challenges for the Distributor
Strategic Needs-Based Internal	<ul style="list-style-type: none"> • Alternatives • Discretionary portfolios • Retirement/Post-Retirement 	<ul style="list-style-type: none"> • Systems, liquidity, minimums • Fiduciary, taxes • Evaluating current demand
Market Opportunities Product Providers	<ul style="list-style-type: none"> • Distressed securities • Market or securities arbitrage 	<p style="text-align: center;"><i>Real or Exaggerated</i></p> <ul style="list-style-type: none"> • Retail packaging • Complexity
Regulatory/Economic Changes Product Providers	<ul style="list-style-type: none"> • UCITS III • China/Russia/Brazil 	<ul style="list-style-type: none"> • Education • Interpreting regulations

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This slide shows how we look at product development. We focus on three key drivers.

The first is strategic needs-based and this comes from us internally. It is our internal assessment of what type of products we think will serve our clients' long term needs.

Among the current opportunities we are exploring and developing, the alternative investments are at the top of the list. Most of our retail clients do not have a lot of exposure to them, but they are interested in adding them to their portfolio. The biggest challenge for us is that most hedge fund of funds and private equity products are not packaged for the retail client segment. The minimum investment amounts are too high and there is not enough liquidity. Most of our clients want daily liquidity. With some of the hedge fund of funds, you are lucky if you can trade once every month. Complexity is an issue, too. Our systems are set up for conventional mutual funds. Handling the processes for alternative instruments that do not offer daily liquidity can be challenging from an operational perspective

Discretionary portfolios are very popular in the private banking world, but not yet in the retail environment. We are running a few pilot programs in this area. One of the challenges we face is developing policies and training for our sales people to take on the role of the fiduciary as this was not one of their previous responsibilities. There are also tax issues. Taxes have generally been favorable for mutual funds. When clients own securities directly, this needs close examination on a country by country basis.

Under "market opportunities" we consider products that are brought to us by external product developers and asset managers. The biggest challenge there is determining whether there is a viable long-term market opportunity or an exaggerated view.


One category we are looking at right now is distressed securities, but we find again that those products are mostly available only via hedge funds and private equity vehicles, with very limited distribution possibilities to retail clients.

Another opportunity where we think we could take advantage of current market developments is via structured notes that try to arbitrage either securities or market events. Many of are complex. We therefore need to make sure that we have all the necessary controls in place and properly address and detail the potential risks to the clients.

The third driver is regulatory and economic changes. Those happen constantly. In the European Union for instance, UCITS III now enables mutual funds to offer more alternative investment strategies. An example are the 130/30 products, which however have not really caught on yet with retail investors, given their short-term performance.

In some large markets – like China, Russia and Brazil – the regulatory environment has begun to open up. We now have new opportunities to distribute our products in those three markets. Our main challenge is staying abreast of the changing regulations and interpreting what those changes mean for investors and products. We want to make sure that we are in full compliance, while making the best use of the new opportunities.

Finally I summarized the key challenges again:

Addressing the Challenges		
• Changing Regulatory Environment	- Staying informed	
• Increasing Product Complexity	- Can be managed as long as underlying investment thesis is solid	
• Fees	- Fee pressure on the distributor yet to be determined	
• Product Development	- Partnerships with key product providers	

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6

Keeping abreast of the regulatory developments in the 42 markets we currently do business in, is a constant challenge. We rely on our internal product development specialists in the various countries, and on the third party product providers and asset managers we are working with.

Product complexity is constantly rising. We are confident that, as long as the investment idea is very solid, we can handle it by putting tight controls in place. We have product committees that review complex instruments regularly, we make sure that our clients understand all potential risks, and we emphasize client education.

Fees: From a product distributors' point of view, we have not seen that much price pressure yet from the clients we serve. That impact is yet to be determined.

Finally, on product development: It is of strategic importance to us to partner with asset managers. We go into new markets together with select asset managers that provide products for us which are suitable for that local client base. This approach has been very successful for us, for the asset managers, and for our clients.

Prof Amin Rajan


ISSA Symposium:

Products and Product Development

A summary of the presentation
given on 4 June 2008

by

Prof Amin Rajan

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My presentation will focus on key trends in product development in global asset management.

Over the past ten years, our research has involved face to face interviews with senior executives in over 1500 fund management houses and 500 pension funds. Today, I will talk about the single most important message that has emerged from these visits. I will then highlight some subsidiary themes.

In fact, that most important message has already been echoed by a number of other speakers today, namely: The fund management industry has passed an inflection point in the bear market of 2000-3. Such a point, by definition, marks a break from the past. The old model no longer applies. The future looks decidedly different from the past.

At the end of 1990s, as the raging equity bull market came to an end, the resulting bear market duly exposed all the fault lines in the fund industry.

Pension funds' funding levels dropped substantially. Clients who had invested in mutual funds lost heavily, too; as did the investors in DC plans. For example, 401(k) plans were first introduced in the US in 1986. Someone who then started by putting in USD 12,500 every year, could expect his/her plan to be worth around USD 250,000 over a twenty year period, even if there had been zero returns. But recent calculations suggest that, over that period, the average balance in those 401(k) plans was USD 58,000. What sort of annuity can you buy with such a sum after 20 years of regular savings?

The old model has clearly failed the clients. Hence there has been a shift into new asset classes.

The new model has to succeed; failure is not an option. That is the key message that has come out from our research.

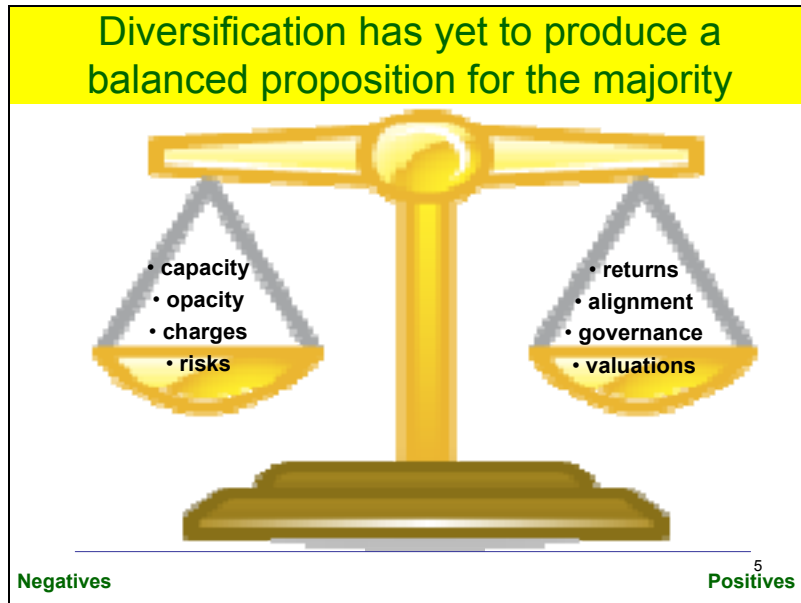
Now I would like to develop three subsidiary themes to support my key message.

Recently I spent a lot of time with pension funds around the world. Their dominant sentiment is summarized by these two cartoons:

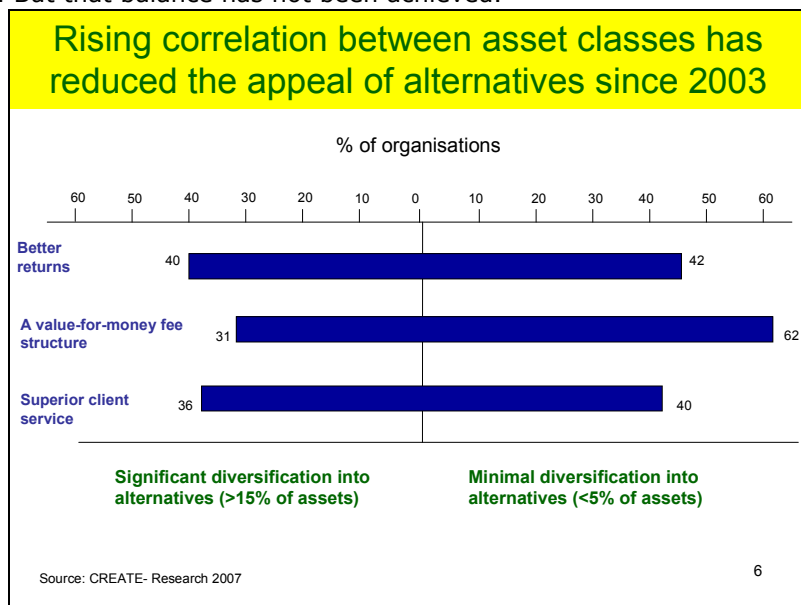


The funding levels have dropped to a point where people feel like jumping out of the window. They just can't cope with bad news anymore. Let me now move on to my subsidiary themes.

We have seen a huge shift towards alternative investments. But the benefits of that diversification have not been clear cut so far.



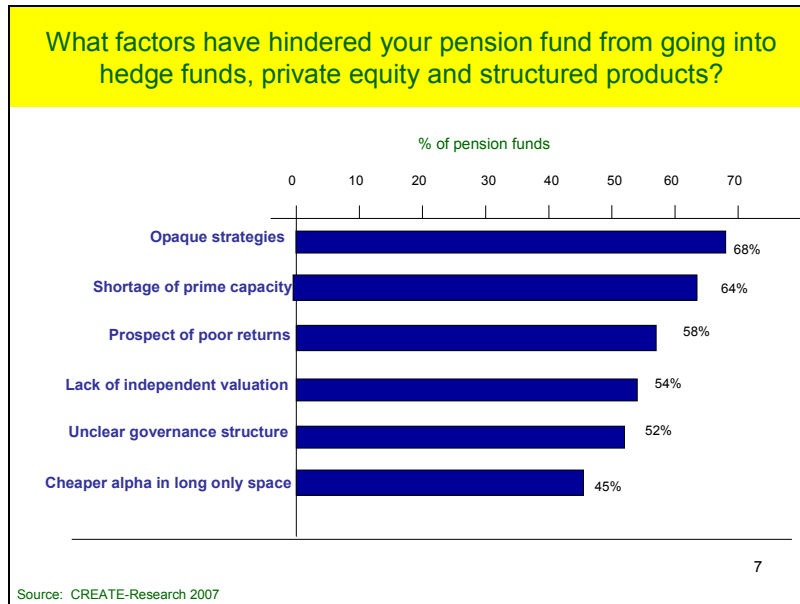
The clients of alternative investments wanted to have a balanced proposition. On one side, clients are willing to put up with opaque strategies, which are capacity constrained very quickly and command high charges strategies. On the up side, however, they want proper alignment of interest, realistic charges and decent returns. But that balance has not been achieved.



I recently visited a prime broker in New York. I came across an internal paper called the "3/97 Report". It turned out that 3/97 meant that 3% of hedge fund managers deliver 97% of the value. One wonders what the other 97% do... Most of those 97% delivered returns that are highly correlated, at best.

From a pension fund's point of view, the proposition of the alternatives has a seductive appeal. The promise is to move from relative returns – which we discovered could not even buy groceries in a bear market – to absolute returns, which are supposed to be uncorrelated to market movements. It is indeed a very seductive idea. But the pension funds are discovering that the concept is not nearly as seductive as it looks. Some of them have actually invested in alternatives since the end of the bear market. So far their returns have not differed significantly, irrespective of whether they had a low or a high diversification into alternatives. The correlation between the so-called uncorrelated classes has turned out to be far higher than anticipated.

Admittedly, the last three years is not a long enough period to identify whether those strategies have worked or not. But in the experience of the pension funds, the results so far have not met their expectations.



There are a number of reasons for that: shortage of prime capacity is the most powerful one. In one of our earlier studies, we found that about 7% of private equity and hedge fund managers could really deliver high alpha on a consistent basis for three years. There were another 56% who were "Wannabes" in the sense that they were second generation, long-only fund managers going into the alternative space for the first time, but they had not really figured out how to generate competitive returns. The rest were "Has beens" in the sense that they were part of the brutal churn that characterizes the hedge fund industry.

We could talk about all sorts of instruments to hedge out the risks. But at the end of the day, Alpha has to come from very talented people; and there is a real concern that there aren't enough of them.

Let me move on to my second subsidiary theme.

Three core themes

- Benefits of diversification into alternatives have been far from clear cut

- *The current credit crisis is a mixed blessing*

"Things that count, often cannot be counted. Things that can be counted, often don't count"

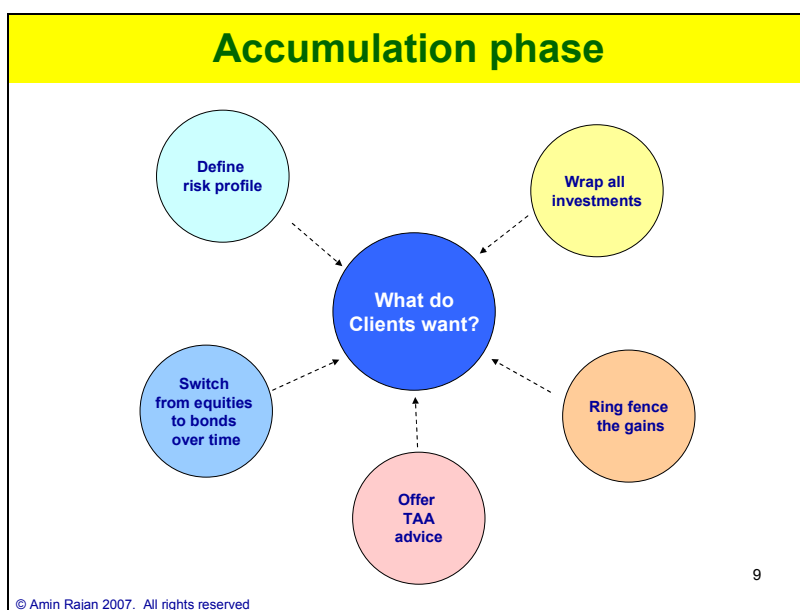
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The current credit crisis has been a mixed blessing. I would even say that it has been a perfect storm in terms of innovation. History tells us that during crisis, there is new regulation, and people change their behaviors. Both factors promote innovation. Currently, there is quite a lot of work going on in designing the next generation of innovative products.

I now want to concentrate on the Defined Benefits (DB) and the Defined Contributions (DC) markets because those are the two areas that we have studied the most.

On the DC side, a new generation of products are being developed which enable clients to define their risk profile early on. There are also embedded solutions in terms of transferring equities to bonds over a period of time. So you have individuals starting out in private DC plans with a high exposure to aggressive equity in the early years, and then there is a progressive switch to conservative bonds later on.

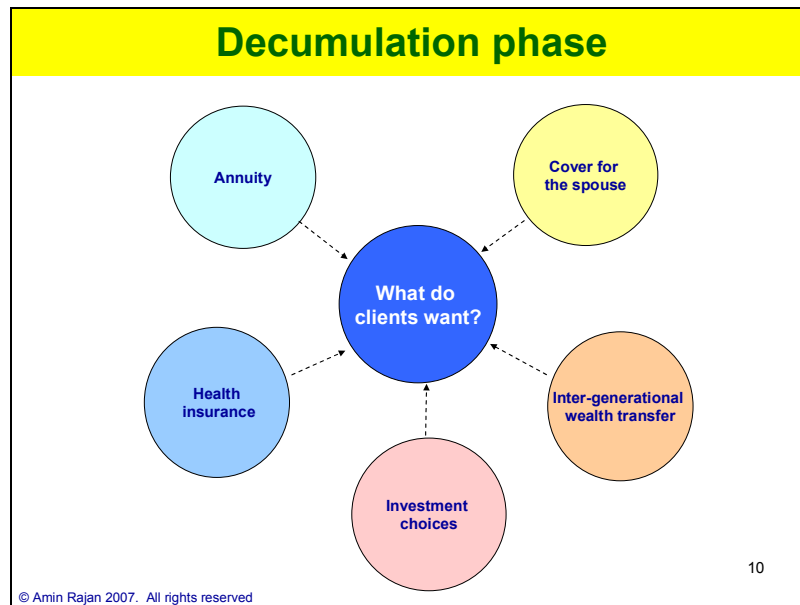
There is a new generation of products coming to the market now, where in the early phase of these plans, a lot of money is being put into cash, instead of equities. It is a measure of how worried people are. They are worried because we had two bouts of extreme volatility in the last seven years. People have lost a lot of money. If I start out with a new DC plan and that plan is underwater right at the beginning, I have no incentive to stay in it. This is a reflection of a change in client behavior: Clients are not just more risk alert; they are also more risk averse. There is a big difference between being risk alert and being risk averse!



At the moment, the main demand is focusing on products which invest upfront in cash, because clients want to have capital protection. This is clearly evident. What we are not seeing, however, are fund managers offering tactical asset allocation (TAA) when the pot is building up. If there had been significant TAA, DC plan holders would not have lost so much, especially in technology stocks. At the time of the high tech boom, many retail clients switched their 401(k) plan money into tech stocks. They were allowed to do it. Then they found themselves sitting on assets that turned out to be extremely volatile and worthless eventually.

In the new generation of products, TAA will be featuring strongly because the demand for it is clearly there. People do not want to invest in a product where there is a lot of automatic switching without capital protection, especially in actively managed mandates. If there is no TAA, what is active management about? If fund managers can't do TAA, then at least they should provide solutions that ring-fence the gains that have accumulated!

Finally, clients want to have all investments wrapped into a single account.



On the decumulation side, however, I do not get the feeling that much is happening.

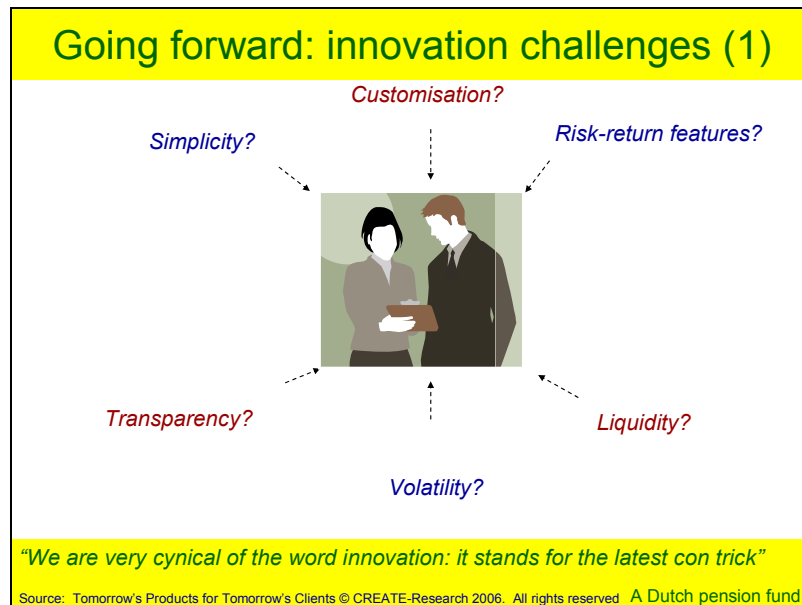
Why do people go into DC plans? The reason why I took out a DC plan was because I wanted my DC plan to replicate all the benefits that are available on the DB plan. If I cannot get those benefits, I might as well spend the money and rely on the state to bail me out in my old days when I am poor. I will choose to be poor deliberately, because if I cannot get those benefits, what is investment all about? But very little is happening at the moment on delivering credible retirement products.

According to our research, what clients want in the decumulation phase, when they retire, is a product which has an annuity. At the moment, buying an annuity at a stand-alone basis is very expensive. They also want health insurance and again, that is very expensive to have on a stand-alone basis. They want to have some investment choices. They also want the possibility to do inter-generational wealth transfer, and they want to have a cover for their spouse.

The solution here is to develop a product which combines a number of benefits and makes sure that some of these benefits are negatively correlated. Therefore, if you enjoy one benefit like your annuity, you are still paying for your life insurance. You are paying for both, but at any one time, you are enjoying only one of them. Because of the negative correlation, you can have a holistic product whose total cost will be less than the sum of its individual parts.

However, we are not seeing substantial progress on the decumulation side. We see annuity rates going up, because of the increasing mortality risk. There is still a lot of scope for innovation in this area. I have no doubt that over the next three to five years, fund managers, life insurance companies and investment banks will sit together and will come up with a product to fit this particular space.

That is the DC side. Let me move on to the DB side.



We are hearing from plan sponsors and pension trustees that, when fund managers or other financial institutions use the word "innovation", they suspect a con trick to fleece the client! Many people have become very skeptical about "financial innovation". So, whenever a fund manager mentions innovation, he should be very specific. When a car producer talks about innovation, he is very specific. He will talk about engine features and brake systems. A fund manager has to be specific about risk/return features. The single biggest worry that pension funds have concerns the risk/return features on which they base their long-term decisions. These features have not been very stable over a longer period of time.

When I buy a meal or a car, there is some degree of predictability about what I am going to get and that is what I base my decision on. But if I base my decision on the assumption that a risk premium associated with equities is five percent, and then I find out that this is not true, it makes the job of long-term investing almost impossible.

So, the first area where we need innovation is in risk/return features. Let's be sure that when we produce a prospectus for trustees, there is some degree of confidence behind it. Trustees want to see maximum improvement here. They want to be sure that the product they are buying will deliver what its prospectus states.

They also want to see improvement in terms of liquidity. This is because many have their liabilities maturing soon. 78 million Americans retire over the next eight years. 80 million Europeans retire over the next 15 years. Therefore there is a great need for liquidity.

They want much less volatility, because of the new accounting rules. With the mark-to-market rules, volatility has become a major issue for sponsors of DB plans.

They want much greater transparency, because of the various fiduciary reporting obligations which they have.

And they want simplicity. Our clients say that the language of fund management and of financial consultants and other service providers uses a lot of sophisticated words to say a lot about nothing. They want fund managers to say in simple words what their product is fundamentally about and what its key deliverables are.

So going forward, innovation has got to be very specific.



The next area concerns housekeeping issues. These have come to the fore in a way that I found surprising. DB plan sponsors and their trustees want to be much more clear about the investment process, about the risk controls in place etc. If we now find ourselves in a world of dynamic risk, where the risk/return characteristics of different asset classes cannot be predicted with a reasonable degree of certainty, we need to make sure that there are proper risk controls in the organizations that manage client money.

Then they are interested in absolute returns rather than relative ones.

They want organizational stability. This is a very important issue according to our research. Stability indicates the degree of confidence with which fund managers can replicate their past success in the future.

Three core themes

- Benefits of diversification into alternatives have been far from clear cut
- The current credit crisis is a mixed blessing

- *After two tipping points, we either accept the world as it is, or change it*

“The reasonable man adapts himself to the world; the unreasonable one persists in trying to adapt the world to himself. Thus all progress depends on the unreasonable man...”


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**Trust is earned, not ascribed :
deeds matter more than words**

Track-record? Alignment? Replicability?

Trust = Credibility + Synchronicity + Stability



“In my relations with others, I listen to their words, but I look to their actions”

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Confucius

Alan Brown

I want to make three points, which are centered around three themes. My points are:

- Institutional issues, building much on what Christoph Schenk said earlier this morning;
- The issue of providing advice; and
- One very short point on investment tools and systems.

The three themes are:

- Change – there is more change going on in the fund management industry right now than ever before in my career;
- The need for investment managers to do a much better job for our clients – what we have been doing for both institutional and retail clients has produced poor value propositions;
- The fact that, in the institutional space, we are moving closer to the retail client segment. We have rarely been concerned about real-world outcomes: How do we pay pensions, not how do we beat market-related benchmarks. That is very close to the private client's need which basically is to earn a real rate of return after all taxes, fees and charges.

Institutional Issues

To put it bluntly, the old model of fund management is bankrupt! The new model, in my view, should look very much like something Christoph Schenk described to us.

What was the old model? You ran an asset/liability study, and the outcome of that was some kind of market-related strategic benchmark. You then drafted an implementation plan which included a mix of active and passive managers. You selected the managers, you funded them, you monitored them and you repeated that whole exercise every three to five years.

If that sounds sensible, it is only because we have been doing this for so long! Actually, it is about as sensible as the Flat Earth Society....

If you think about it, all of our governance effort has concentrated on controlling risks on the portfolio we owned, against the benchmark that we had chosen. In most funds, those risks were small, sometimes trivially small.

The risk gap between the benchmark and the liability we were trying to pay was the big risk out there, and we were looking at that only every three to five years. We had the 80/20 rule applied completely the wrong way around. And if you looked at our benchmark world, everything looked rather perverse: If you chose to overweight index-linked securities, benchmark-based that was risky. Yet, in the real world context that was typically risk reducing.

So, what was the change, what is the new paradigm Christoph was talking about?

It is the recognition that the liabilities of a pension fund must remain the benchmark against which one must measure success or failure, throughout the entire process and not just every three to five years. Market-related benchmarks now become secondary.

I am arguing that the generic model for best practice today is as follows:

It starts with a serious conversation between the trustee and the plan sponsor, the outcome of which is a monetary risk budget. The question then is how to spend that risk budget. Are you going to match all, or some of your liabilities? It might be perfectly reasonable not to. You may take the view that liabilities 40 years out are so uncertain, that it may not make sense to match them. Or you may take the view that with real interest rates at 0.5%, it does not make sense to buy into that, so the term structure of interest rates may matter. You might use a part of your risk budget for maintaining – or not – a duration mismatch.

Besides that, you need to manage your cash collateral. There is some risk to be taken for that.

Finally, you have to have a growth portfolio – something that will make your pension proposition affordable. Hopefully, it will be a sensible-looking growth portfolio, not the kind of growth portfolios I have seen during most of my working life. Those were deeply undiversified because they were exposed to basically just one risk, and that was equity market Beta.

Why does building a portfolio like Christoph described take so long? The academic model is easy to understand, and it is perfectly rational. Why did we have to go through that bubble and bear market before we finally caught on to this?

As an industry, on the way up, we kept congratulating ourselves. Fund managers, even if they underperformed the benchmark, were still producing 20% returns. They did not need to do anything. And when the bubble burst, there was a lot of wringing hands as we realized that we were not doing anything! We behaved like a deer caught in the headlights, not knowing whether to go to the left or to the right.

That takes me to the last element of this new generic process: The question of how should your risk budget change, as your state of wealth, i.e. your funding ratio, goes up or down? Shouldn't we have that conversation *before* we meet that event?

There could be perfectly rational, different responses. I like to use the examples of British Airways and British Telecom. Both of them had huge deficits at the bottom of the last bear market. The response of British Telecom was to throw another few hundred million pounds into their fund every year, until the problem went away. If you were BT's trustee, why would you have wanted to change that? BT could easily afford it. But in the case of British Airways, those funds were not easily available, therefore the trustee's response needed to be different.

The framework for managing pension funds today is far away from what I have seen in the last twenty or thirty years. It represents a huge departure, and a huge need for us to create alternative products. Not the super-specialized small-cap fund with a growth bias – that is out.

We need the skills of people who know how to address that risk budget and to define a real outcome-based strategy. What basic fixed-income based strategy is there today which provides any kind of value proposition to the end client? If yields are 4% or 4.5% and we take out 125 basis points as total expense, what is left for the end client? Why are we even offering such products?

Briefly, on outcome-based products for the individual – going back to the decumulation phase which Professor Rajan explained – and the very high price of annuities: We all would love to give our clients real inflation-protected annuities, if we could possibly deliver that on an affordable basis. Market rates at the moment simply won't let us do that. So what else can we do?

There are things we can do a little bit smarter. For instance, we can take distributions from high returning assets like equities, and rebalance them. We could sell capital gains to generate extra income. You could take an equity yield capped product, sell the upside of that portfolio to generate a 7% income return, and still leave the client with the ability to participate in the first 10% of the upside. That is not a bad proposition for a retired person! As an industry, we still have a long way to go before we really meet the needs of those who are still in the asset accumulation phase.

Providing Advice

Let me give you two examples. The first concerns my son. He wanted my advice on what to do with his pension plan. His employer's proposition was for the employees to put up 3% and the company would match that with another 3%. They recruited an Independent Financial Adviser to discuss with the staff what they could do with those 6%. Neither the employer, nor the Independent Financial Adviser, nor the government, nor any of the fund managers that might have been involved in the process gave him the most important piece of information that my son needed: A 6% contribution is wholly inadequate to provide a decent pension at all!

Who is prepared to take the responsibility for that? I understand the issues around legal responsibility, but somewhere, somebody has to face up to the fact that people have to be told about this. Nobody working outside our industry can determine the right level of contribution on their own. We have to step up to that.

The second example: Some years ago, the Head of the UK Financial Services Authority gave a speech to an audience that represented all sectors of the investment industry. He made one comment, directed to the retail sector in particular: Should I accuse you all of mis-selling? Shouldn't you have documentary evidence from your client, before you sell him anything, that he doesn't have any long-term outstanding credit card debt? Why? Because you cannot, with any of your products, compete with a 17% guaranteed after tax return!

My answer is "Yes you should." But two years on, has the FSA moved? No, because the vested interests in the industry are so strong, that this will not happen. But actually, clients should be told that, before they even think of investing, they should pay off their long term credit card debt.

Investment Tools and Systems

Just another brief point to illustrate how much room for improvement there is in our industry: The standard tools that we provide to our fund managers and that most people use for the creation of portfolios treat upside risk identically to downside risk. How crazy is that? One risk you would love to take all day long, the other you want to avoid like the plague! And yet, these tools are used every day to build institutional portfolios, because we operated in a benchmark-based world rather than in the real world. So, there are opportunities for the systems providers to get into the real world and recognize that upside and downside risk are important things to model and to price differently. We as an industry must raise our game.

And that is my message: Across the whole panoply of what we are doing, there is a huge challenge for our industry – to do a better job for our clients.
