


Balanced Clients Portfolios:  
Pre-Crisis and Post-Crisis

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### 1. Looking back – The evolution of balanced portfolios up to 2007


I was asked to make a contribution towards setting the frame for the next two days' discussions. A good way to set the frame is to take a brief look back, to recall where we are coming from.

#### Typical balanced portfolios at the turn of the millennium

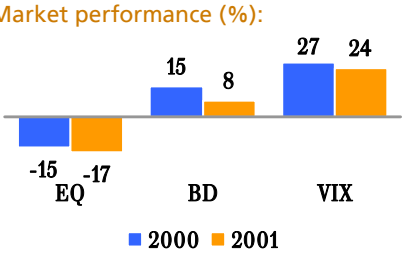
**"Typical" discretionary balanced portfolios in 2000/2001**

- ◆ Cash
  - For cash flow management, rebalancing, FX trading
- ◆ Fixed Income
  - Domestic bonds (mainly government bonds), Some corporate bonds, UBS funds
- ◆ Equities
  - Long only; domestic, with some extra international companies; single names; UBS funds in (local currencies)
- ◆ Few structured products
- ◆ Virtually no Alternative Investments
  - Hedge Funds, Private Equity, Real Estate, Commodities
- ◆ Clients needed more stable portfolios
  - Especially after the burst of the tech bubble and the corporate scandals in USA.

**Asset allocation:**




**Market performance (%):**



Category	2000 (%)	2001 (%)
EQ	-15	-17
BD	15	8
VIX	27	24

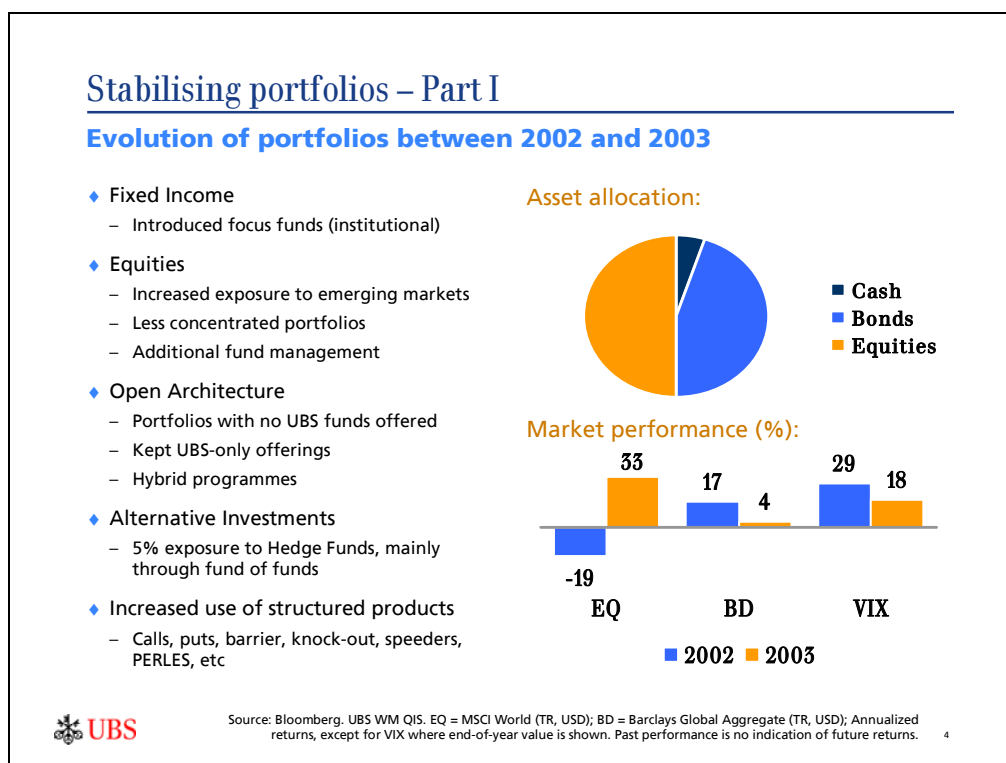
Source: Bloomberg. UBS WM QIS. EQ = MSCI World (TR, USD); BD = Barclays Global Aggregate (TR, USD); Annualized returns, except for VIX where end-of-year value is shown. Past performance is no indication of future returns. 3



Let's take a typical discretionary balanced portfolio as it looked ten years ago. All of my examples are, by the way, UBS examples only, not the result of extensive industry field research.

You see the asset allocation of the "good old days": a large proportion each of equities and bonds, plus some cash. Bonds were mainly domestic and government bonds, equities were long only. If you were adventurous, you had some international equities in your portfolio. If you had a really high risk appetite, you would have a few emerging market stocks. You had no or only very few structured products and virtually no alternative investments.

Many clients wanted simple, stable portfolios as they had just been hit by the "Tech Bubble" at the turn of the century. However, if you look at the volatility of those portfolios, it was quite high.



Now we advance a few years: We see the emergence of institutional funds to save money for the clients. But that also complicated matters a bit. We see more exposure to emerging markets, less concentrated portfolios. An important new element appeared: open architecture. Banks started to sell third-party products, no longer just their own. This led to increased turnover, and for instance to the operational problems with transferring mutual funds which you are all familiar with. Alternative investments started to become visible as an asset class, and structured products in countless variations began finding their way into the portfolios.

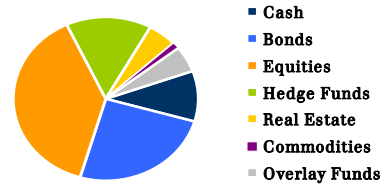
Performance generally was not bad in 2002/2003. Markets picked up, especially equities, while bonds came down. Volatility decreased, so it paid off to have risk in your portfolio.

## Stabilising portfolios – Part II

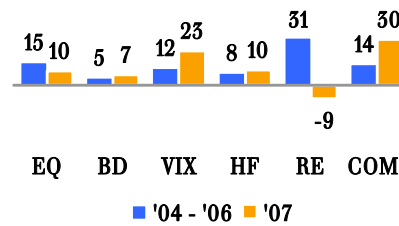
### Evolution of portfolios between 2004 and 2007

- ◆ Increased diversification
  - Across countries, asset classes, issuers, maturities, strategies
- ◆ More structured portfolios
  - Sector portfolios; Bond Strategy portfolios; Multi-Manager Funds
- ◆ Fixed Income
  - Global hedged; higher allocation to Emerging Markets, High Yield & Corporates
- ◆ More comfortable with Alternative investments
- ◆ Use of overlay funds
  - In-house cost-efficient alpha seeking funds

#### Asset allocation:



#### Market performance (%):

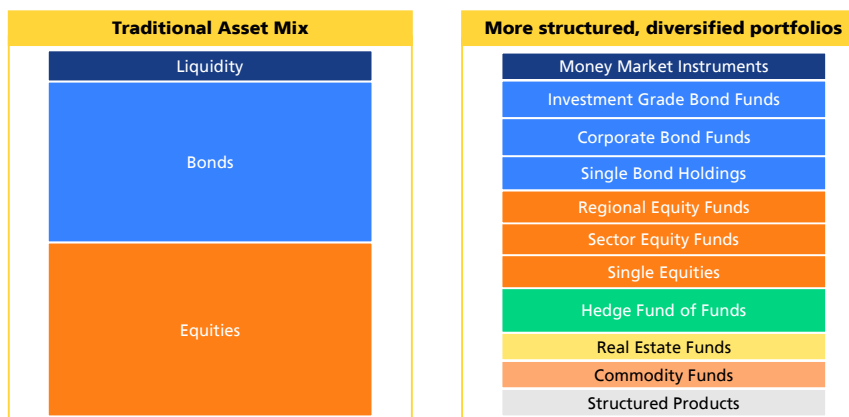


Source: Bloomberg, UBS WM QIS. EQ = MSCI World (TR, USD); BD = Barclays Global Aggregate (TR, USD); HF = HFRI FoF, RE = GPR 250 Global; COM = RIC Index. Annualized returns, except for VIX where end-of-year value is shown. Past performance is no indication of future returns. 5

This trend continued and accentuated in the years 2004–2007. Portfolios diversified further, hedge funds, real estate, commodities and overlay funds were new additions. The beauty of it was that everything except real estate yielded positive results; all markets went up.

## Portfolios after 7 years of evolution

### More structured & diversified portfolios...



For illustrative purposes only. The above asset classes, asset allocation and investment instruments are indicative only and can be changed at any time at UBS' discretion.

... designed to create an optimal asset blend.

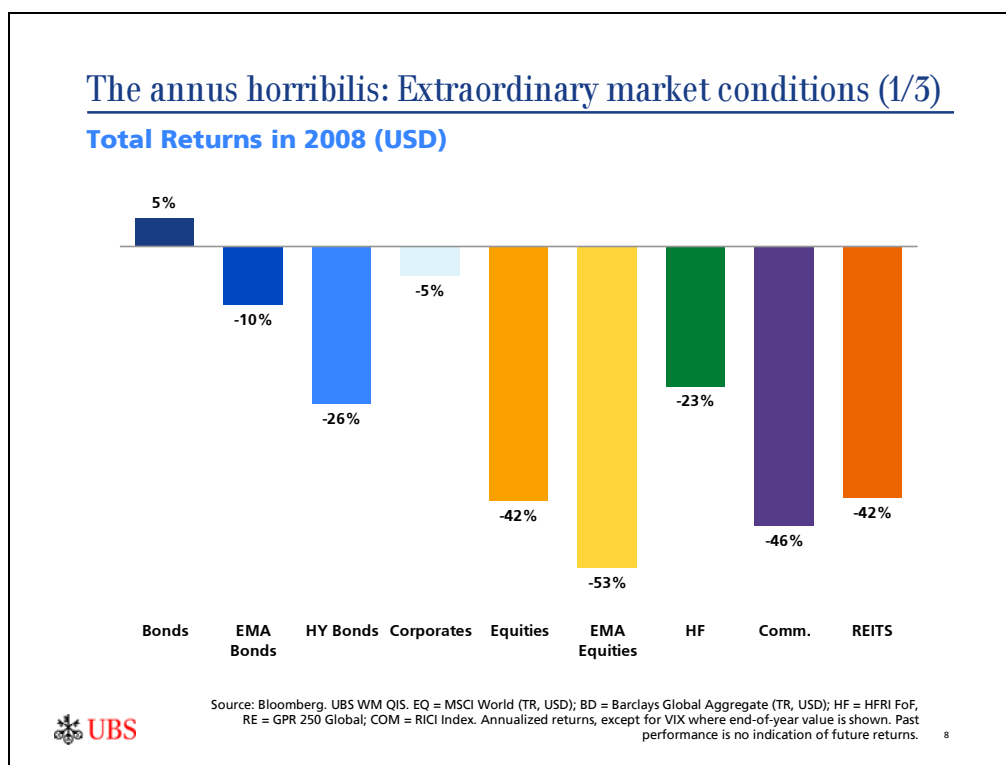


Please always read in conjunction with the glossary and the risk information at the end of the document. 6

After seven years of portfolio evolution, investors thought that they had now come away from traditional, simple portfolios and achieved a perfect portfolio diversification. In reality – look at the colors – they essentially had just more variation of the same. I remember that we had this discussion two years ago and you had observed how all those

new products created a heavy additional workload on operations. But on the client side, everyone was happy, because returns were good, and the clients thought that they were highly diversified and therefore safe. And then the crisis hit!

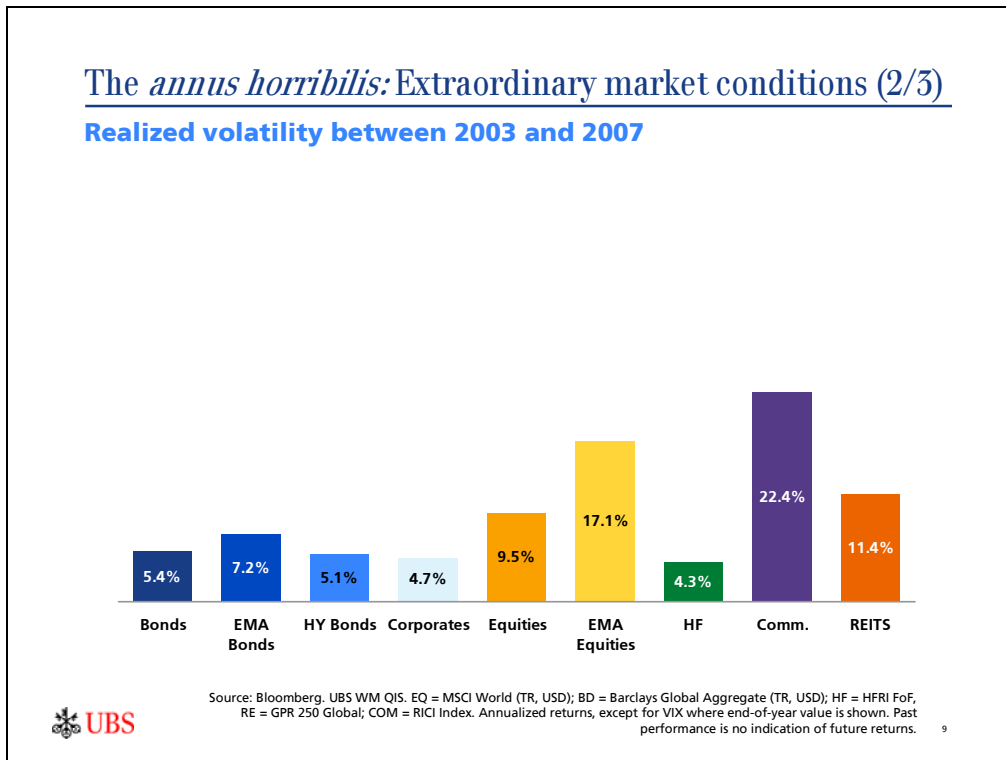
## 2. The challenges posed by the financial crisis



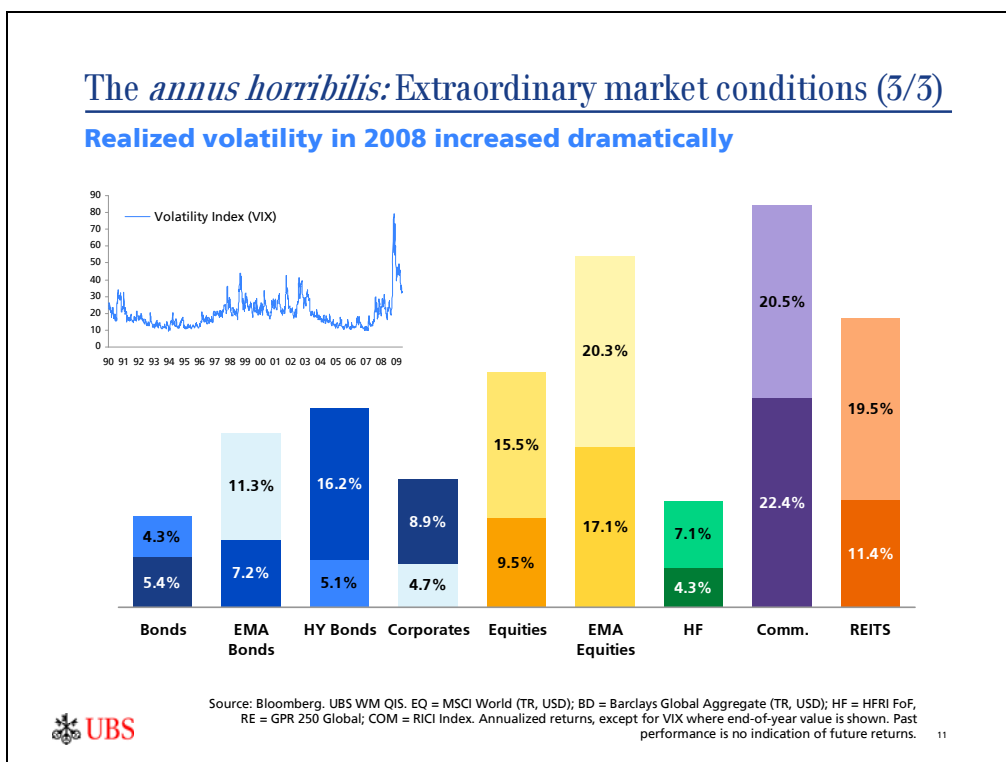
Look at this picture now: Except for government bonds, all asset classes declined sharply. The seemingly well diversified portfolios turned into a nightmare. Despite the many new instruments that had been created by the asset managers, the feeling of safety and diversification turned out to be an illusion.

The crucial issue is not "How many instruments do I have and in how many markets?" but "What kind of risk did I buy and how much of it?"

Don Donahue mentioned the 1.2 zettabytes of data in existence today, of which only 5% are structured in a way so that they can be analyzed by a computer. This is reflected here, too. We had such a lot of change and rapid growth in just a few years, and only a small part of all the evolution was based on well structured information. Nobody could really catch up with it, and then the financial crisis accelerated the situation even more.



Before the crisis, when client advisors discussed with their clients their risk appetite, a 9.5% volatility in equities, for instance, was what the clients knew and were used to. When they agreed to introduce some more risk into their portfolios, they expected and accepted something like the volatilities you see here. 22% volatility in the commodities market was considered a very high risk, suitable only for the most adventurous clients.




And then, the crisis all of a sudden revealed the real dimensions of risk. In almost all asset classes, volatility more than doubled! That shocked the clients because normally, in rising markets, volatility falls. Neither the clients nor their advisors were used to real risk

anymore. Even bonds now had a volatility that you would normally see in equities. It was for the first time in many years that risk really came alive again. We are still in the aftermath of that shock wave. This picture explains why the markets are still so nervous today.

### Challenges during the crisis

#### Negative returns, higher correlations, increasing defaults...

- ◆ Most asset classes delivered negative performance
- ◆ Short-term correlations increased dramatically
- ◆ Alternative assets collapsed
  - Alternatives were added to stabilise portfolio returns but
  - HF's had their worst year ever and
  - Real estate became illiquid.
- ◆ Liquidity dried up
- ◆ Market participants were punished for being overly confident
  - Many had increased their exposure to risky assets...
  - ... and some had used leverage!
- ◆ Issuer risk came to the fore
  - ◆ Banks defaulted and some collapsed, capital protected products defaulted, increasing effect in portfolios.
- ◆ Value of active management was seriously questioned
- ◆ Company specific issues
  - Profitability, accounting and write-offs
  - John Doe Summons , Cross border Taxation
  - Media


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Most asset classes delivered a negative performance. All showed a large degree of correlation in the short term, there was no diversification effect anymore. The hedge funds – originally created to stabilize your portfolios – crashed alongside the rest of the market. So, many investors stood there and said to the hedge fund managers: "Thank you very much for lying to me!" But let's be fair here: Even the hedge fund managers have investment plans that are tailored to "normal" circumstances. Saying that the hedge funds did not perform as an asset class – in one of the three most exceptional years in the last one hundred year period – is a harsh judgment. But clients started to realize that they should not take everything their advisor told them at face value. That loss of trust is another big problem that still persists today.

Investors found out that assets they had thought to be highly liquid were not. The value of liquidity had been lost or underestimated by many – clients as well as advisors.

Many clients had become so overly confident in the markets and in their own skills that they had leveraged – some of them heavily – and everyone profited from it: banks, brokers, investors, governments. The entire system was leveraged.

Everything culminated in 2008, and the system went into shock. Banks started to default and collapse – some as a result of investors de-leveraging as fast as they could. In the beginning of the crisis, nobody wanted to be in a hedge fund anymore, because hedge funds were hit the strongest. Hedge funds are prime broker-driven, and much of the prime brokerage business depends on credit. And if there is a credit crunch, all of those leveraged structures will come down quickly. You did not even have to have a clear view of the market, all you needed to do was take a close look at the system you were in at that time, and then you drew your conclusions. Counterparty risk became a very big concern.

What do investors do if they lose money because they were overconfident? They start to ask questions, they start to educate themselves. Clients started to question the "fancy products". When they realized that not even their bankers could understand or explain all the products they found in their account statement, the situation became unsustainable.

### Clients reaction

#### Quotes from client meetings

"I want more liquidity!"

"No fancy products!"

"No black boxes in my portfolio!"

"I don't want so much UBS exposure"

"Active management does not work!"

"I need bigger shifts in my portfolio to protect my capital"

"I want to be more involved!"

"I don't believe in 'the long term'"



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What you see here are actual client statements.

Clients drew contradictory conclusion as well. On the one hand they did not see the value of active management anymore, because it had failed to protect their capital. On the other hand, they demanded bigger shifts in their portfolios to accomplish better capital protection...

Many clients did not want to delegate investment decisions anymore, they wanted to be involved. They experienced that they were not rewarded for taking risk in the last ten years. They observed that, simply buying government bonds in 2000 and waiting for ten years, would have yielded the same or even better results. So, many clients lost their belief in the value of long-term investment strategies.

So what did we do to address all those immediate concerns?

### 3. Addressing immediate concerns

Focusing on our clients' needs...

**... without compromising their investment objectives**

<ul style="list-style-type: none"> <li>◆ "I want more liquidity!"           <ul style="list-style-type: none"> <li>– Have created mandates without alternative investments (e.g. Managed Wealth Portfolio)</li> <li>– Keep mandates with AI for clients with the appropriate time horizon</li> </ul> </li> <li>◆ "No fancy products!"           <ul style="list-style-type: none"> <li>– Have created programmes with restricted use of structured products (e.g. MWP, Swiss line mandates)</li> </ul> </li> <li>◆ "No black boxes in my portfolio!"           <ul style="list-style-type: none"> <li>– In RR programmes we have liquidated Tactical Overlay Funds</li> <li>– Rebalancing of HF allocations</li> <li>– Assessing options in NTAC</li> </ul> </li> <li>◆ "I don't want so much UBS exposure"           <ul style="list-style-type: none"> <li>– Controlling issuer risk in portfolios</li> <li>– Continue to have open architecture products</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>◆ "Active management does not work!"           <ul style="list-style-type: none"> <li>– Contradicts other clients</li> <li>– Use of ETF and Investment themes (e.g. WMP, Swiss line mandates)</li> <li>– Improved risk management (eg. AR)</li> </ul> </li> <li>◆ "I need bigger shifts in my portfolio to protect my capital"           <ul style="list-style-type: none"> <li>– Need to risk profile clients appropriately</li> <li>– Big shifts can also mean big loses of opportunities</li> <li>– Match appropriate product to clients</li> </ul> </li> <li>◆ "I want to be more involved!"           <ul style="list-style-type: none"> <li>– Special Client mandates with restrictions</li> <li>– Core/satellite approach?</li> </ul> </li> <li>◆ "I don't believe in 'the long term'"           <ul style="list-style-type: none"> <li>– TAA takes more importance</li> <li>– Benchmark unconstrained programmes more popular</li> </ul> </li> </ul>
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The challenge is how to focus on clients' needs without compromising their investment objectives. But the simple truth remains: there is no perfect world. If you want higher returns than just interest on cash, you have to accept a certain level of risk. The question then is, what kind of risk clients will be prepared to take, and how much of it.

We created portfolios without alternative investments, or only for an appropriate time horizon. We created portfolios with a very restricted range of structured products. We eliminated products most clients could not understand, such as tactical overlay funds which were heavily futures-driven. Non Traditional Asset Classes (NTAC) – basically funds of funds – were used only very selectively.

We continued to offer third party products but capped issuer and counterparty exposure. For instance we did not allow more than 20% of a portfolio to have a counterparty exposure to UBS.

The perceived need for bigger portfolio shifts is the most difficult challenge to address properly. Clients had experienced the impact of volatility. They fear it and they now want to avoid it. But they generally do not want to buy protection, for instance in the form of put options, because they find it too expensive. They are rather looking for someone who can shift their portfolio. So the clients are actually exchanging the market risk for the skill risk of their portfolio manager. But if you want an equity portfolio and at the same time you are not prepared to lose 5% of it, why do you want an actively managed portfolio in the first place? If you want shifts from stock into cash and back all the time, guess what that does to your transaction costs. The more sensible way to advise such a client would be to change into a portfolio with a maximum of 20% equities in it. That would have the same effect.

"I want to be more involved!" That is very challenging as well. We have around 120,000 mandates at UBS Switzerland, of which 95% are "push-button" products. If all those

clients wanted more personal involvement, we could not possibly handle the workload anymore.

Most clients' investment target expectations are very much formed by their personal experience during the early part of their working life. Sixty year old clients often expect a 7-8% return because they experienced high inflation in the 1970s. Thirty year old clients may be happy with 4% because they never lived through a high inflation and high interest rate period.

We have to use more and more skill risk to satisfy different client needs. On the one hand, if interest rates go up, some problems will go away. On the other hand, if interest rates really went up high, that would put the entire hedge fund business under pressure. Why?

If you are a pension fund and the actuarial rate is 4%, and the bond markets give you 5%, you would probably buy only bonds. But if yields are falling below 4%, the only way to escape is by adding risk to your portfolio. That is where the hedge funds came in. They profited from falling interest rates, and their business grew very fast. If interest rates are really rising high, the hedge funds will have to deliver very high "after fee" returns to justify the risks they are taking. That is where we are heading. So if we want to continue with the current business model, we have to hope for interest rates to stay low, otherwise some service areas in our industry will be severely impacted.

## The future structure of portfolios

### Don't throw the baby out with the bath water

- ◆ Risk management takes centre stage
  - Enhanced risk management! ...
  - ... with a better understanding of risk!
    - Financial, legal, issuer, reputational, operational,...
    - Downside management; Volatility; VaR; Tracking error; Shortfall risk,...
  - Currency hedging is taking a more prominent role
- ◆ More stringent risk profiling and management expectations
  - Better understanding of clients needs and expectations. Agreement of time horizon.
  - Managing expectations after exceptional returns (both positive and negative!)
- ◆ More flexibility on asset allocation
  - Benchmark unconstrained solutions may be more popular
  - Active TAA... but passive vehicles
  - Tactical Overlay Funds may survive as satellites
  - "Local" mandates
- ◆ Discretionary or advisory?
  - Hybrid products may be the way forward
- ◆ Back to simplicity... More transparency and overall, tighter risk controls!
  - The question is to find the right balanced between simplicity and efficiency.



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Risk management now takes the center stage. In order to decide what kind of risk to buy for a client portfolio, a much more detailed client profile must be created in the first place. The client's needs and expectations must be known and the latter may have to be managed. We have to become more flexible in our asset allocation and go for the core/satellite approach. We also notice that investors do not value diversification through cross-border investing that highly anymore. Post-crisis, many prefer local products. Not necessarily because they are superior, but simply because they are close. Swiss clients ask for Swiss Franc bonds because they are available. They want to buy companies like

Novartis and Nestle, because they can follow in their local newspaper what those companies are doing, and that gives them a greater comfort level. That is a clear trend.

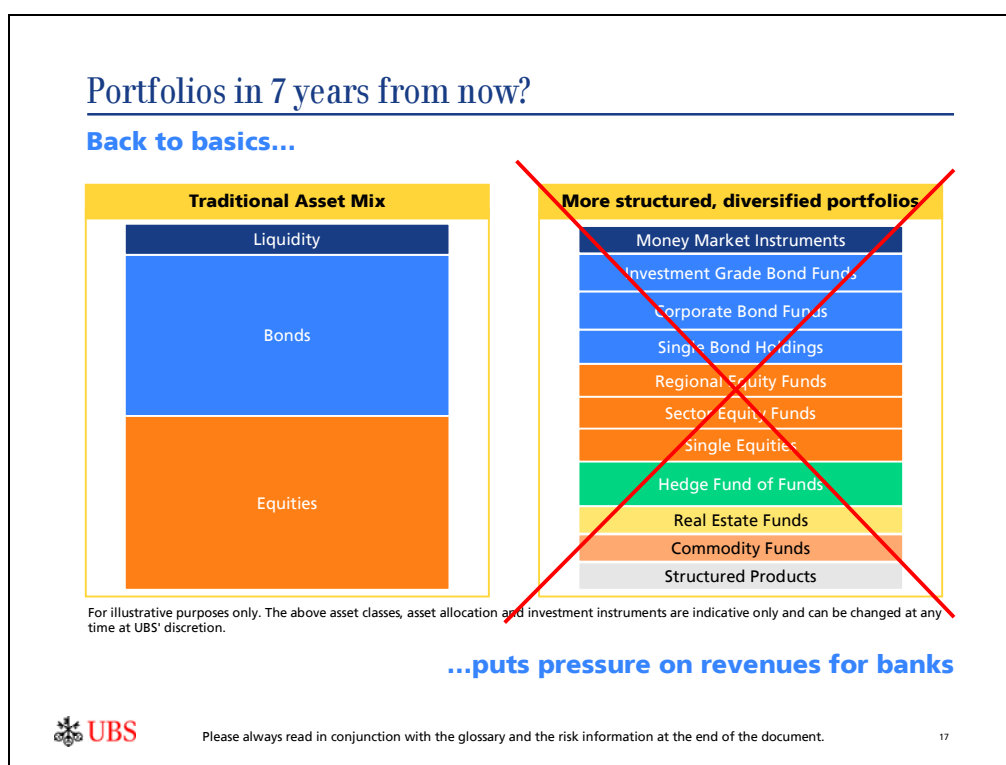
In between giving the bank a strict discretionary mandate and wanting to take all investment decisions independently, we will see new hybrid portfolio management structures.

Returning to simplicity is a clear trend. For us in Portfolio Management, this translates into the challenge to be both simple and efficient, to address the client's needs and yet be highly productive as a factory in the mandates business.

What about passive investing? It has become much more important and it is here to stay. However, it is not the universal answer. We will need to have a good mix of active and passive strategies.

In the future, clients want to know exactly what they pay for. They do not want to just see what they pay for a management mandate; they want to see the Total Expense Ratio (the TER). They are already more sensitive to high margin products and their awareness will increase even more. That will remain.

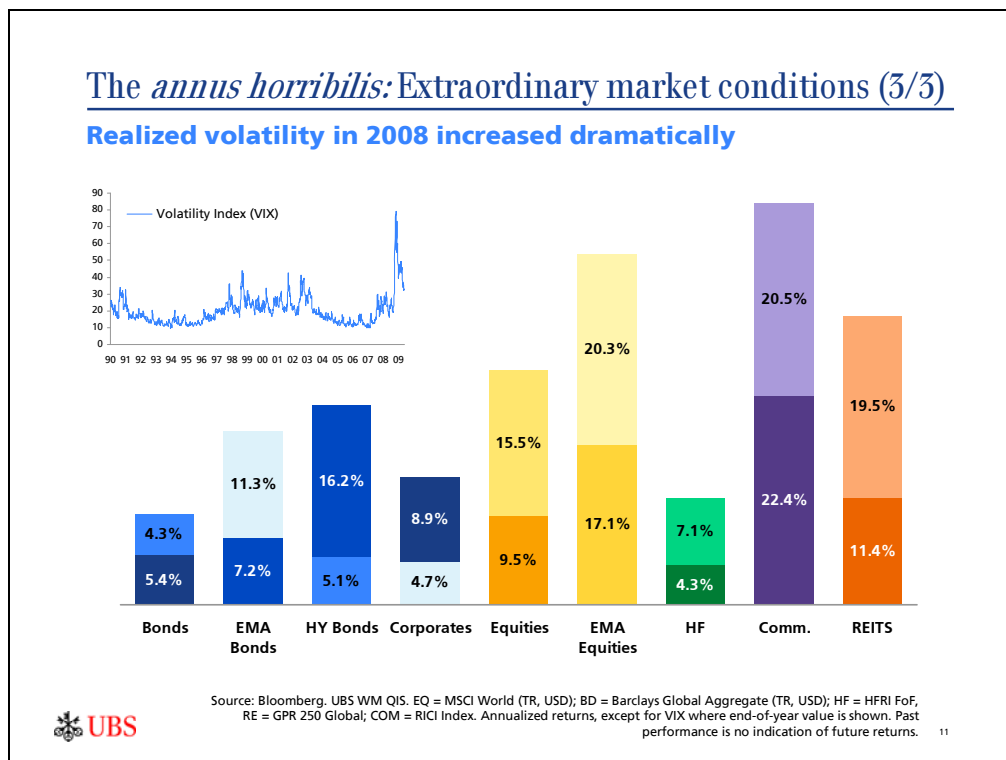
There is also a different reason why you should not do everything passive: You have the full momentum risk, i.e. you are always fully exposed to the movement of a market overall and have no way to react in a targeted way.



Where will we be seven years from now? Back to the basics?

Yes, back to the basics, but it will not be quite as simple as shown in this picture. The future asset allocation will focus less on instrument classes, but more on risk types. We have to get the dimension of risk management right. We can only add value if we slice the right side of the graph according to the risk types we need to manage. At the end of the day, what we need to achieve is not diversification of investment instruments but diversification of the risk factors.

But, if we go into that direction, not only for the mandates business, and if we want to escape the associated revenue drop, banks need to be very efficient, large scale and they have to have skilled staff to face their clients. If wealth managers do not have that, the next wave of crisis will wipe them away, because one thing will stay: volatility.



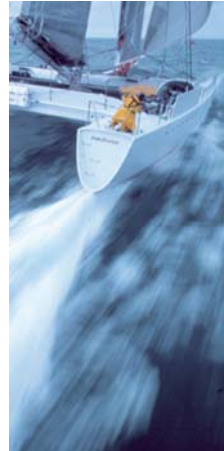
This picture really says it all: We will see more shifts. For operations departments, the pressure will increase as the number of transactions will increase, and this will probably not go away for the next five to ten years. It takes that long for the clients to learn what risk really means. And that is also a challenge we are facing ourselves. Trying to find the Holy Grail that would allow us to avoid risk altogether is the wrong way to go. We cannot hope to avoid risk entirely. Given that simple truth, we should embrace the risk and deal with it.

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## Risk Information

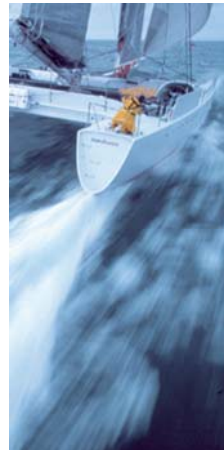
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