Best-laid plans

PETER WÜTHRICH DISCUSSES HOW TO CREATE AN INVESTMENT STRATEGY

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Wealth management has become a mainstream topic in most modern societies, as a period of low interest rates seems to have turned into the 'new normal', leaving traditional saving accounts increasingly unattractive. Even though various economic and social developments seem to have increased investment risks or lowered returns, the investment market continues to devise innovative and attractive investment strategies, and the determined wealth holder keeps searching for them.

A GOOD STRATEGY

The wealth management industry, dominated by large banks and asset managers, caters to those needs by offering investment services claiming to help their clients' capital grow over time. More advanced investors manage their wealth on their own with the same goal.

Common in both instances is the necessity of basing investment decisions on a sound strategy. The investment strategy considers:

- the overall financial plan;
- short- and long-term objectives;
- risk tolerance; and
- preferences.

When implemented successfully, the investment strategy anticipates:

- issues related to the governance of the investment programme;
- optimal asset allocation;
- implementing the investment programme with banks and asset managers; and
- monitoring and reporting the results.

DIFFERENT METHODOLOGIES

What sounds rather straightforward in theory often turns out to be less easy to accomplish. Financial institutions use different theoretical foundations, both to derive the client's investment strategy and to assess the attractiveness of the various investment opportunities. Unsurprisingly, the use of different methodologies leads to different results. Unfortunately, there is no right and wrong here; since finance is a social science, empirical evidence looking for the best investment strategy will always be mixed. The investor should be aware of the approaches applied in their case and decide whether the assumptions are reasonable and in line with their values and goals.

Further, the incentives for having a well-documented investment strategy in place differ between the financial service provider and the investor. For a bank, it is mainly a regulatory compliance matter to offer maximum protection against claims made by unsatisfied clients. After the global financial crisis of 2007–2009, the amount of risk disclaimers in client contracts quadrupled, on average. The investor's motivation for having a suitable investment strategy is to avoid becoming unsatisfied with their investment results in the first place. To accomplish this, the investment strategy must cover more than just statistical risk targets and ranges.

The negative effects of misaligned investment strategies or, even worse, not having a strategy at all, are severe. The most common issue is that a mismatch often leads to the abandonment of the investment strategy at the worst possible time, particularly after experiencing financial losses from the investments. Estimates from online brokerage data show that investors who stop following their investment strategy during temporary market dislocations, like the ones in the first quarter of 2020, give up 5–7 per cent return potential per year, with many extreme cases of quick bankruptcy when financial leverage was involved.

CONCLUSION

As strategic alignment seems to be an important driver for the achievement of long-term investment goals, it is key that the investor's understanding of, and preference for, certain types of investment risk matches with the risks taken by the chosen investment strategy. The assessment of the preferred investment style is important, because the usual steps of assessing the investor's risk awareness and risk tolerance deal only with the amount of risks that the investor should take, not the types of risk.

The additional assessment of the risk types should support confidence in the quality of the investment strategy, helping the investor to go through difficult times of losing money in the short term. Investors who have no deep knowledge of investment styles need guidance to set an investment strategy they can follow over the long term.

#INVESTMENT

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