

How the World's High-Net-Worth
Grow, Sustain, and Manage Their Fortunes



WEALTH



Associates of
Merrill Lynch and Capgemini

*Foreword by Robert J. McCann, Merrill Lynch
and Bertrand Lavayssière, Capgemini*

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To Our Clients and Our Colleagues

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FOREWORD

Our Eight Convictions about the Future of Wealth Management

By Bertrand Lavayssière, Managing Director of Global Financial Services for the Capgemini Group and Bob McCann, Vice Chairman and President of Global Wealth Management at Merrill Lynch & Co.

The world is witnessing the greatest period of wealth accumulation in history. Never before have so many people from so many different regions of the earth become so wealthy in so short a period of time. And never before have so many opportunities existed to create new wealth, both as the natural outcome of new ideas and the product of existing capital appropriately and prudently leveraged. Due to the downfall of the Berlin Wall in 1989, coupled with the concomitant rise of global capitalism and globally integrated capital markets, the twenty-first century presents an unprecedented opportunity for innovative and entrepreneurial spirits to profit from these long-term secular trends. This will continue to fuel the concentration and consolidation of wealth at the unprecedented velocity witnessed over the past decade. Although economic disruptions and volatility can by no means be relegated to history, we firmly believe that the future of global capitalism is bright. In support of this belief, we have documented and validated eight convictions, which we are



convinced will continue to shape the world of wealth as it evolves in the twenty-first century.

Eight Firmly Held Convictions Regarding the Future of Wealth Management

Based on our collective experience, extensive research and dozens of interviews conducted specifically for this book, we have developed eight firmly held convictions regarding the future of wealth management. We will illustrate all eight throughout the book by using detailed examples and case studies. We will demonstrate the myriad ways by which wealthy investors and their financial advisors, as well as the broader community of aggressive and informed investors worldwide, can materially benefit from the wide universe of wealth creation opportunities before us.

1. The global economy and investment focus for high-net-worth individuals is evolving from a two-pole world dominated by Europe and North America to a multi-polar world including Asia and the Middle East.
2. This multi-polar evolution will accelerate as an unprecedented wave of wealth transfer occurs, putting assets into the hands of a younger, more internationally focused, technologically savvy generation.
3. Diversification of investments across different investment vehicles, asset classes and geographies will be the key to consistent and, at times, superior performance.
4. New investment products will continue to arrive at a rapid pace, accompanied by rapid obsolescence and product cycles. As in the past, early adopters may benefit substantially before a new product is commoditized and returns inevitably revert to the mean.
5. Investor sophistication—the ability to understand these new products, to invest in them and to compare them—will depend on a mixture of cutting-edge technology, information and expertise.

6. Investors will have an increasing responsibility to stay informed and educated. They must be ready to engage and question their financial advisors about wealth management strategies. They must participate in the dialogue.
7. Family education around financial issues will become increasingly important to demystify money, create family unity and prepare children to be good stewards of capital—whether through investments or philanthropy.
8. Business ownership will remain the main driver of wealth creation. Business owners will increasingly demand that advisors manage their wealth as professionally as they manage their own businesses, prompting advisors to offer an ever-broader and deeper range of financial products and services to the wealthy and ultra-wealthy.

TAKING FULL ADVANTAGE OF A WEALTH OF OPPORTUNITIES

The recent growth of global wealth prompts an obvious question: How can the wealthy (and those of us who aspire to join them) and their families maximize their returns, commensurate with their risk appetite, in a rational and measured way that permits them to sleep at night while achieving their increasingly complex financial and personal goals? The purpose of this book is to provide some insightful working responses to this question. Not only are we convinced that the current era promises an unprecedented opportunity for abundance, but that all of us can share in the seemingly limitless prosperity of our era.

While the various topics treated herein may be of keenest interest to present and aspiring possessors of wealth, the rapidly increasing population of financial advisors and their associates will find much to provoke their interest and stimulate discussion of the ever-shifting landscape of wealth management. While we can by no means



guarantee that we will address every question posed by professionals, we can offer assurances that most of the broader dimensions of this holistic wealth management process have been covered.

When Capgemini and Merrill Lynch published their first *World Wealth Report* in 1997, the goal of the project was modest and simple: to compile and distribute a discrete set of data points, conclusions and insights describing an explosively expanding class of individuals whom we dubbed HNWIs (“high-net-worth individuals”),¹ individuals with more than US\$1 million in financial assets—and about whom the financial services industry of the time knew astonishingly little.

We could not have known then that this project would inadvertently give birth to the now commonly used acronym, HNWI (pronounced by the cognoscenti as “HUNWEE”) which would be destined to take pride of its place in the popular parlance of the burgeoning wealth management industry. As we began more closely to observe, track and interpret the distinctive needs and behaviors of these individuals, we identified an even more rarefied class of investors with financial assets in excess of US\$30 million, which we subsequently called ultra-HNWIs (ultra-high-net-worth individuals)² who exhibited behaviors more institutional-like than the “average” HNWI.

APPRECIATING WHAT A DIFFERENCE A DECADE MAKES

The world of wealth described in that first seven-page report was positively quaint by today’s standards. In 1996, the number of dollar millionaires had just topped six million; ten years later the ranks of the wealthy had swelled to nearly ten million. In 1996, the pool of assets controlled by the wealthy stood at approximately US\$17 trillion. By 2007, that number had surged to US\$37 trillion.

1. HNWIs are defined as individuals with US\$1 million in investible assets, excluding their primary residence.

2. Ultra-HNWIs are defined as individuals with US\$30 million in investible assets, excluding their primary residence.

The approximately twenty trillion dollars in newly accrued assets accumulated by the wealthy and ultra-wealthy over the past decade represents not only a trend toward ever-greater wealth consolidation and concentration, but also its accelerating globalization. In 1996, the most dynamic regional wealth generators worldwide were in Asia and Latin America, although all the emerging markets were shortly to be significantly if briefly disturbed by the onset of economic contagion from Asia and its fallout. This included the disruptive default on Russian sovereign debt, which first raised its ugly head in the summer of 1997.

We also documented a trend by which many of the world's wealthiest individuals and families were abandoning traditional private banking havens in Switzerland in favor of offshore centers in the Caribbean. Additionally, we identified a behavioral pattern that has since accelerated, as the wealthy and ultra-wealthy diversified their portfolios to embrace a number of then-radical and exotic investment strategies, loosely grouped under the generic term "alternative investments."

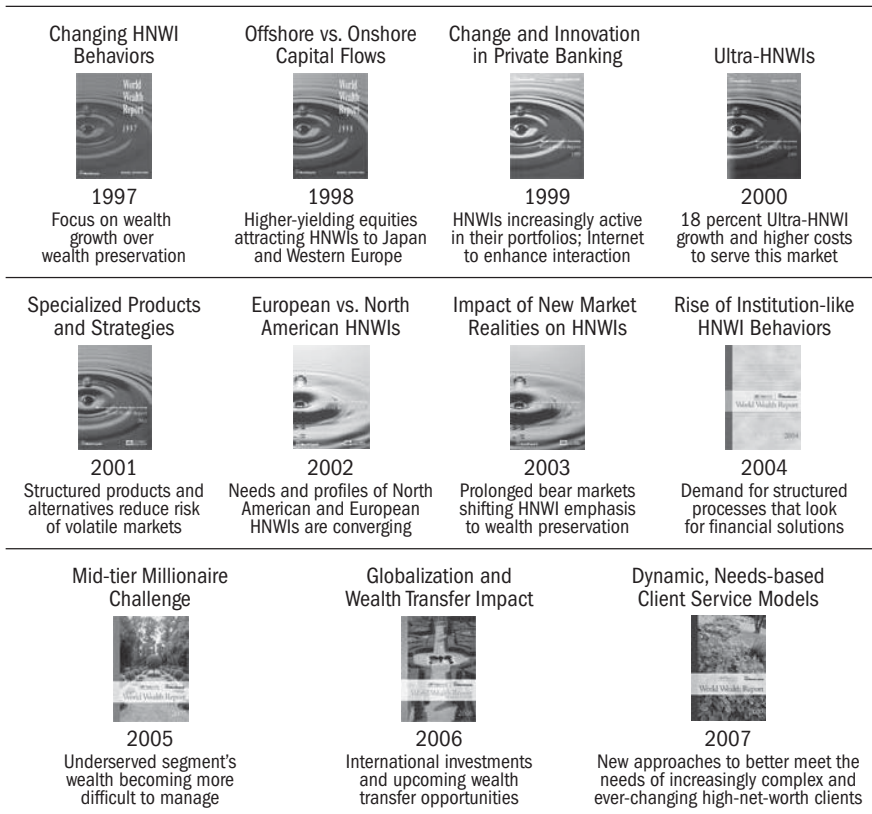
Whether those alternative investments included taking the plunge into frontier emerging markets, making a proprietary private equity placement, or perhaps purchasing one or more holdings from a rapidly expanding menu of comparatively exotic structured financial instruments and vehicles,³ the penchant of the wealthy and ultra-wealthy to seek enhanced performance closely mirrored an increased appetite for measured and structured risk—i.e., alternative investments—on the part of institutional investors. By late 2007 and 2008, however, the global credit crunch threatens to cast many of the rosy scenarios underlying these pooled assets into question.

3. The Committee on the Global Financial System (CGFS) provided the following definition of structured finance in its January 2005 report, *The Role of Ratings in Structured Finance: Issues and Implications*: "Structured finance instruments can be defined through three key characteristics: (1) pooling of assets (either cash-based or synthetically created); (2) tranching of liabilities that are backed by the asset pool (this property differentiates structured finance from traditional "pass-through" securitisations); (3) de-linking of the credit risk of the collateral asset pool from the credit risk of the originator, usually through use of a finite-lived, standalone special purpose vehicle (SPV)."



A brief history and synopsis of the ten-year trends can be found in Figure 0.1.

Figure 0.1 – *World Wealth Report* Spotlight Sections, 1996–2007



From 1997 to 2007, the number of HNWIs grew at an annual rate of 7.6 percent, from nearly six million to nearly ten million. At the same time, their financial assets surged at an annual rate of 8 percent, to US\$37.2 trillion from US\$16.6 trillion. In 2006, for the first time, the Forbes 400 was composed strictly of billionaires. HNWIs, who tend to be older than the general population and hover somewhere on the cusp of traditional retirement age, have been saving and spending in their lifetimes according to patterns and strategies quite different from the wealth accumulation and preservation strategies

employed by their parents. What is more, as these wealthy individuals pass their assets on to their children, they will in all likelihood usher in a new generation, armed with a different mindset and approach, which is likely to give rise to yet newer forms of investment methods and strategies. The profound social and economic implications of what is predicted to be the largest intergenerational transfer of wealth in history will be discussed at length in later chapters. This growth over the past decade is broken down into an annual timeline in Figure 0.2 below.

Figure 0.2 – *World Wealth Report Scorecard, 1996–2006*

HNWI Global	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Financial Wealth (US\$ trillions)	16.6	19.1	21.6	25.5	27.0	26.2	26.7	28.3	30.7	33.4	37.2
Number of HNWIs (millions)	4.5	5.2	5.9	7.0	7.2	7.1	7.3	7.7	8.2	8.8	9.5

Source: Capgemini Lorenz Curve Model; Capgemini/Merrill Lynch 2007 *World Wealth Report*

Running concurrently with these long-term economic and demographic trends has been the overarching phenomenon of globalization, coupled with the advent of sophisticated technologies that have integrated the world's capital markets while fostering the creation of a steady stream of complex financial instruments. If two decades ago the financial services industry resembled a mom-and-pop sidewalk food stand offering a mere handful of plain-vanilla entrees on its menu—stocks, bonds and mutual funds—today's financial marketplace more closely evokes a full-service restaurant located inside a five-star hotel, replete with smiling and eminently capable *mâitres d'hôtel* and a concierge prepared to meet—and ideally anticipate—every conceivable need, articulated or not, of the discerning investor.

The popularity of structured instruments—including collateralized debt obligations and other forms of asset-backed securities, some of which courted controversy and even outright incredulity during the credit crunch of 2007—is clearly responsible for a



significant proportion of the new wealth spawned within the first decade of the twenty-first century. Yet broader access to these high-performance and often high-risk vehicles (the Porsches and Maseratis of the financial world) has not come without cost or anxiety. The sheer complexity of such instruments demands a level of expertise to fully comprehend and navigate through their exotic universe and has only increased the value of expert guidance and advice to baffled yet justifiably intrigued clients. Many of today's structured products require advanced math degrees not only to create, but even to comprehend.⁴ The global nature of these investments also means that numerous tax and regulatory jurisdictions may come into play, further enhancing the chances that expert guidance in the field will be required by clients and advisors alike when engaging with a wide variety of products.

Just as the *World Wealth Report* colorfully accomplished over the past decade, this book will trace the evolution of the financial services industry, from its comparatively humble beginnings as a straightforward purveyor of stocks, bonds, mutual funds and garden-variety investment advice to the affluent masses, to a globally distributed group of high-level custom-shops or boutiques, frequently contained within and supported by global financial powerhouses, and offering a staggering array of products and services precisely targeted at the wealthiest of wealthy individuals and households. We will also provide guidance on the strategies and insights developed by many HNWI's to take full advantage of the plethora of often exotic products and services on the menu.

4. Among the most commonly formulated structured finance instruments:

- *Asset-backed securities* (ABS) are bonds or notes based on pools of assets, or collateralized by the cash flows from a specified pool of underlying assets.
- *Mortgage-backed securities* (MBS) are asset-backed securities whose cash flows are backed by the principal and interest payments of a set of mortgage loans.
- *Collateralized debt obligations* (CDOs) consolidate a group of fixed income assets such as high-yield debt or asset-backed securities into a pool, which is then divided into various tranches.
- *Collateralized mortgage obligations* (CMOs) are CDOs backed primarily by mortgages.
- *Collateralized bond obligations* (CBOs) are CDOs backed primarily by corporate bonds.
- *Collateralized loan obligations* (CLOs) are CDOs backed primarily by leveraged bank loans.
- *Credit derivatives* are contracts to transfer the risk of the total return on a credit asset falling below an agreed level, without transfer of the underlying asset.

As we noted a decade ago, the traditional world of the obsequiously discreet and low-key private banker was even then fading fast into a dusty past. “Private banks can no longer expect to receive handsome fees for providing old-fashioned trust and investment management services merely to protect assets from inflation or domestic taxation.” Clients then, as now, “are becoming increasingly sophisticated and demanding...and expect not only outstanding service but consistent strong performance, active wealth management, and a multi-market investment strategy.”⁵

Family offices and multi-family offices that provide tailored advice to an exclusive and limited network of families, relatives and friends have continued to proliferate in the HNW universe. Financial services boutiques (many located within larger institutions) that strive to maintain the high-touch intimacy of the traditional private bank have continued to thrive. Several of the largest financial institutions have been quite aggressive in preserving the best of the private-banking tradition by carving out private banks within their larger wealth management divisions, while supplementing the skill sets of their high-production private bankers with expertise drawn from the broad array of activities conducted by the firm.

LEVERAGING HOLISTIC WEALTH MANAGEMENT TO MEET THE DEMANDS OF THE MASERATI INVESTOR CLASS

Wealthy and ultra-wealthy investors’ perennially urgent demand for convenient and comprehensive access to markets and information has given rise to a dazzlingly broad range of bespoke products and asset classes. The most avid consumers of these new asset classes consist primarily of a new client class we have labeled “active performance-driven investors.” While once upon a time the average wealthy investor might have sought out a private banker for his or her

5. 1997 *World Wealth Report*; Capgemini/Merrill Lynch.



high-end investment advice—probably the same private banking house that served his or her parents or grandparents—today’s more versatile, knowledgeable and empowered HNWI’s are inclined to take a broader view of their entire financial picture. This broader view has in turn ushered in an era of financial service in which a comparatively small number of firms with a global footprint are prepared to combine the intimacy of a financial boutique with the intellectual capital of a financial powerhouse.

Active performance-driven investors require returns backdated into the past and thrusting far into the future, encompassing asset allocation, risk management, credit, tax strategies, insurance, estate planning, college planning, financial education and philanthropy—not to mention the occasional provision of a sought-after ballet ticket, entree to an intimate lecture by a world-class financial expert, or possibly even a financial boot camp for their children so they are more fully grounded in legacy issues and the ins and outs of intra-generational wealth transfer.

When a HNWI turns to a wealth manager in our era, he or she invariably demands to know about and perhaps even fully understand the identity of the newest exotic investment vehicle being offered, much as the same discerning consumer might prefer to acquire a custom-made designer suit as opposed to a mass-production item pulled straight off the rack. Whether it is the most secure risk management tactic, the latest estate tax strategy, or the best way to structure a charitable foundation in accordance with local tax law, the inherent complexity of managing wealth in this day and age demands a genuinely holistic approach.

Particularly for many of the more recently minted HNWI’s, as well as for entrepreneurs so often busy building their businesses that they lack the time or inclination to dwell on wealth management issues, it is critical to grasp the fact that a more holistic wealth management view offers the surest path to wealth for the broadest class of discerning investors. For advisors, it pays to know that HNWI’s

will increasingly expect this breadth of service. For large banks, with complex global structures, it has become all the more urgent to break down silos and integrate across lines of business and geographies to provide the holistic service HNWI's need and will expect.

In our chapter on investor sophistication, we examine the remarkable strides in financial literacy among HNWI's, arguably driven by three factors:

1. The enormous amount of information available via the Internet, which allows HNWI's to educate themselves more easily than ever before;
2. Globalization, which has forcibly broadened HNWI's investment views;
3. Steadily increasing household liquidity. Through initial public offerings and private equity buyouts, entrepreneurial HNWI's, or those with a family business, may suddenly find themselves with tens or even hundreds of millions of dollars on hand, which they must wisely allocate across asset classes and geographies.

A key finding here is that as HNWI's become more engaged than ever before in their investments, they are less and less self-directed. HNWI's will continue to require and value the high-level expertise and sophistication that a good financial advisor can bring to the table. That may be good news for advisors, but it also means that HNWI's are relentlessly raising the bar of expectations for them. They fully expect their financial advisor to understand and explain how products fit into the overall portfolio. Or, depending upon the product or instrument in question, they expect their advisor to be in a position to call upon the right expert to add their specialized knowledge to the relationship—a synergy that private banks cradled within global financial institutions and offering a wide array of products and services excel at delivering.