Barclays Wealth Insights

Volume 9: New horizon, new behaviour

In co-operation with the Economist Intelligence Unit

BARCLAYS
WEALTH

About Barclays Wealth

Barclays Wealth is a leading global wealth manager, and the UK's largest, with total client assets of £145bn, as at 31 December 2008. With offices in 25 countries, Barclays Wealth serves affluent, high net worth and intermediary clients worldwide, providing international and private banking, investment management, fiduciary services, and brokerage.

Barclays Group is a major global financial services provider engaged in retail and commercial banking, credit cards, investment banking, wealth management and investment management services with an extensive international presence in Europe, the Americas, Africa and Asia.

With over 300 years of history and expertise in banking, Barclays operates in over 50 countries and employs over 155,000 people. Barclays moves, lends, invests and protects money for over 48 million customers and clients worldwide.

For further information about Barclays Wealth, please visit our website www.barclayswealth.com.

About this report

Written by the Economist Intelligence Unit and commissioned by Barclays Wealth, this ninth volume of Barclays Wealth Insights looks at the responses of high-net worth individuals to the current market environment, with a particular focus on investor behaviour.

It is based on two main strands of research. First, the Economist Intelligence Unit conducted a survey of more than 2,100 high-net worth individuals, with investable assets ranging from £500,000 to in excess of £30 million. Respondents were spread globally, with the highest numbers of respondents from the United States, Hong Kong, India, Singapore, Canada, Spain, Switzerland, the United Arab Emirates, the United Kingdom and Monaco. The survey took place between March and May 2009.

Second, the Economist Intelligence Unit conducted a series of interviews with economists, senior executives and wealth experts from around the world. Our thanks are due to the interviewees for their time and insight.

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Foreword

At Barclays Wealth, we are dedicated to providing our clients with the means to manage their wealth successfully. For this reason, we are committed to investing in research to better understand the value of wealth and its importance in the future.

In partnership with the Economist Intelligence Unit, we have developed the ninth volume of *Barclays Wealth Insights*, a series of research reports which aim to provide a definitive picture of what being wealthy means in the 21st century.

As well as consulting with 2,100 wealthy individuals globally, the Economist Intelligence Unit worked with a panel of international experts drawn from academia, industry and financial circles, to provide additional insights and perspectives.

In this report *New horizon, new behaviour*, we take a close look at investor behaviour around the world, following a turbulent and testing 12 months. Over this period, economies, institutions and investors have all encountered dramatic changes to the financial world. *New horizon, new behaviour* sheds light on the practical and behavioural implications of this and examines how investors are adapting to a new landscape.

Whilst it is encouraging to note that investors recognise that there are opportunities out there, there is also a degree of uncertainty over when to make their move back into the market, and into which asset classes.

I hope you find this report an informative and entertaining read.

Thomas L. Kalaris
Chief Executive
Barclays Wealth

Our Insights Panel

Viral Acharya, Professor of Finance at Stern School of Business and London Business School

Dan Ariely, Alfred P Sloan Professor of Behavioural Economics at Massachusetts Institute for Technology

Brad Barber, Maurice J and Marcia G Gallagher Professor of Finance at the UC Davis, Graduate School of Management

Roy Chen, Director of Sterling Private Management Limited, a Hong Kong-based family office

Greg Davies, Head of Behavioural Finance at Barclays Wealth

Florence Eid, Managing Director for the Middle East and North Africa at Passport Capital

Simon Gervais, Associate Professor at Duke University: The Fuqua School of Business

Rory Gilbert, Head of UK & Ireland Private Bank London Region, Barclays Wealth

Daniel Kahneman, Professor of Psychology and Public Affairs, Emeritus at Woodrow Wilson School, Princeton University

Kenneth Kuttner, Professor of Economics at Williams College

Carol Pepper, Head of Pepper International, a financial advisory firm

Guillaume Taylor, Partner at de Pury Pictet Turrettini & Co, a financial advisory firm

Bart Van Ark, Chief Economist, The Conference Board, a business membership organisation

In addition to our panelists quoted in the report we would also like to extend our thanks to the following people who provided insight into the development of the content:

Alan Botterill, Managing Director for HR Services Europe at Towers Perrin, a consultancy

Nassib Ghobril, Head of Economic Research at Byblos Bank

Scot Hofacker, Chief Financial Officer, EXEL Americas, a logistics company

Charles Honneywill, a Partner in transactions at Ernst & Young (EMEA)

Miles Templeman, Director General, Institute of Directors, a business membership organisation

Carson Wen, Partner, Jones Day, an international law firm

Introduction

After a long, dark winter in the global economy, the arrival of the new year brought scattered sightings of green shoots. From Ben Bernanke, Chairman of the Federal Reserve, to Jean-Claude Trichet, President of the European Central Bank, there has been a succession of high-profile policy-makers claiming that the worst of the downturn may be over. Meanwhile, stock markets around the world rebounded between March and May 2009, with some indices rising by more than 30 per cent.

Yet despite this encouraging news, it is clear that there is still a long way to go before we see a sustained economic recovery. The scale of the imbalances to be absorbed remains significant and a return to solid growth, particularly in the UK, Eurozone and Japan, is still a relatively distant prospect. In addition, some commentators have suggested that the recent strong stock market performance is little more than a bear rally – a short-lived high that runs counter to a longer-term trend of falling prices. It is clear that these remain challenging times for anyone attempting to read the market and make the right investment choices.

The aim of this report, which was written by the Economist Intelligence Unit and commissioned by Barclays Wealth, is to examine how today's fast-changing economic environment is affecting investor behaviour. Based on a survey of more than 2,100 mass affluent and high-net worth individuals, the report explores the responses of wealthy investors to the current period of uncertainty, and draws on insights from the world of economics and psychology to assess how a combination of rational and irrational behaviour is affecting their investment decision-making.

Executive summary

Fear is preventing the wealthy from investing, even where they see opportunity. While prospects for most asset classes and the global economy remain highly uncertain, recent market rallies and wider discussion of the “green shoots” of recovery have raised the question of whether a turn in the cycle may be imminent. Almost 90 per cent of the high-net worth investors questioned for this report say that the current environment offers buying opportunities but, crucially, 68 per cent believe that the risk of further price falls is too high to consider them. In addition, only a minority of 28 per cent say that they will increase levels of risk in their portfolio over the next 12 months. This widespread sense of caution and risk aversion highlights the extent to which wealthy investors have been chastened by the events of recent months and suggests that it may be some time before confidence returns to the market.

High-net worth investors are sticking with the status quo. Asked how they expected to change their asset allocation over the next 12 months, the majority of investors say that they will make no adjustments at all to the proportions that they hold across major asset classes. For example, 58 per cent say that they will make no change to their allocation to domestic stocks, while 65 per cent say that they will neither increase nor decrease their exposure to hedge funds. Behavioural finance experts questioned for this report suggested that a pervasive “fear of regret” is impeding more decisive action among many wealthy investors and encouraging them to stick with the status quo until they feel they have a better understanding of the situation.

High-net worth investors are seeking the comfort of simplicity and familiarity. More than 50 per cent of investors agree that, in the current environment, they will only invest in what they know. Where respondents are seeking greater exposure to specific assets, it tends to be to the most “straightforward”, with real estate, cash, government bonds and domestic equities the most likely beneficiaries of increased allocation. The perception that complexity – in the shape of financial assets such as collateralised debt obligations – played a central role in the current crisis is only exacerbating this trend.

Action on the financial crisis has yet to restore trust among investors. Many of the survey respondents are unimpressed with the way the financial crisis has been handled by central banks and governments. Investors from India, Spain and Hong Kong are most likely to offer a negative assessment of policy-makers’ handling of the crisis. Even a politician as feted as President Obama does not escape criticism: only one-third of wealthy investors in the US believe that his administration’s performance during the crisis has been successful. The survey respondents are also strongly critical of the media, with less than one-quarter of respondents believing it to have been successful in its handling of the financial crisis.

Transparency and quality of information are becoming watchwords for wealthy investors. Due diligence is rising up the priority list for many high-net worth individuals, with almost half of respondents saying that they intend to increase the amount of time that they spend selecting specific investments. Equally, when choosing a financial provider, the quality and transparency of investor information is becoming much more important as a criterion for selection, along with the financial stability of the institution.

Investor behaviour:
the rational and the irrational

Rarely have finance and economics been so widely discussed and scrutinised. Just two years ago, concepts such as Libor rates, credit derivatives and quantitative easing were confined to the specialist financial press, but today they are the subject of everyday conversation as retail and high-net worth investors try to get to grips with a dramatically changed economy. The speed and severity of the downturn has had a profound effect on the investor psyche, while the timing and nature of a future recovery continues to be hotly debated by both experts and laypeople alike.

What cannot be denied is that the rate of decline in the global economy has started to slow, following a constant flow of increasingly dire economic news over the past 18 months. Moreover, there have been tentative signs of recovery in some countries, most notably in China. If it is indeed the case that the green shoots of recovery are now pushing through, high-net worth investors may need to consider changes in asset allocation as financial markets typically discount a recovery four to six months before it occurs.

The past two months have seen a strong rally in equity markets that few would have expected at the start of this year. For example, the S&P 500 has risen by more than 30 per cent since its low in March, while the Shanghai Composite Index rose more than 40 per cent between January and May.

While it is far from certain that these gains will be sustained, they do suggest that, for investors who are prepared to take the risks, there are significant investment opportunities available. Bart Van Ark, Chief Economist at The Conference Board, a business forum, notes that global growth in 2009 "could very well be positive rather than negative".

But if the data are showing only that the deterioration is slowing after the global economy "fell off a cliff" in the final quarter of 2008, a switch from a defensive portfolio could be premature. A sustainable recovery in economic activity is needed to boost corporate cash flows and underpin valuations. Without this, the current rally may prove to be short-lived.

This poses a dilemma for investors that is unlikely to be resolved quickly. Economic and financial data tend to send conflicting signals at possible turning points. "We will only know how severe the recession will be over the next six to nine months," says Viral Acharya, Professor of Finance at Stern School of Business and London Business School.

Despite evidence supporting a more bullish asset allocation, there is still plenty of cause for concern. Unemployment is rising and is bound to continue on an upward path for much of 2009. Job losses, combined with pay freezes and cuts, will dampen consumption and investment. This effect will be amplified by balance-sheet adjustments as firms, households and banks sell assets to pay down debt accumulated during the credit boom.

This could leave investors exposed to the risk of a double-dip recession and – in the worst-case scenario – a multi-year slump characterised by debt-deflation, similar to the so-called "Lost Decade" that Japan experienced in the 1990s. "If consumer expenditure picks up very quickly in the second half of this year, this could lead to a rapid recovery that might be more than business conditions can bear," says Mr Van Ark. "In turn, that could lead to a double-dip recession."

Reasons to be cheerful?

- The run-down of inventory adjustment which drove the collapse in industrial output has run its course, and companies now need to rebuild stocks to meet demand. This is confirmed by recent encouraging data on new orders.
- The collapse in international trade flows appears to have bottomed out.
- There is some evidence of a pick-up in US housing transactions (although prices continue to fall).
- UK retail sales figures have been better than expected.
- China reported GDP growth of 6.3 per cent year on year for the first quarter, slower than the double -digit rates of recent years but by no means bad.
- Measures of consumer and business confidence have been improving across the world.
- Conditions in interbank markets are easing.
- There is a nascent revival of primary issuance in both equities and high-yield bonds.
- Spreads on emerging market bonds and corporate bonds are tightening.
- Emerging market equities are on a substantial rebound.
- Base metals, which are geared to the economic cycle, have risen strongly from their recent lows.

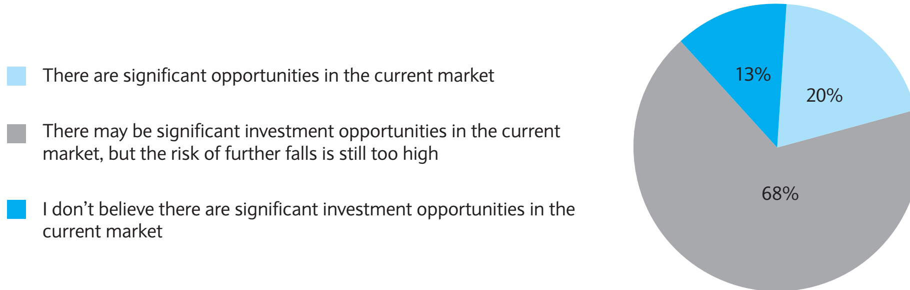
Opportunities – and fear

None of the scenarios described above – even the more unpalatable ones – would be without opportunities for investors and the high-net worth individuals questioned for this survey appear to recognise this. Nearly 90 per cent of respondents said that there were opportunities in the current market but, crucially, 68 per cent of them believe that the risks of further price falls are still too high to consider them.

There are small regional differences: for example, investors in the US seem most inclined to view the current environment as one of opportunity without fearing further price falls, while those from Monaco and Spain are least inclined to take this view. In general though, there is a very strong consensus that now would be a good time to make certain investments. Yet at the same time, fear is preventing the majority of high-net worth individuals from re-entering the markets.

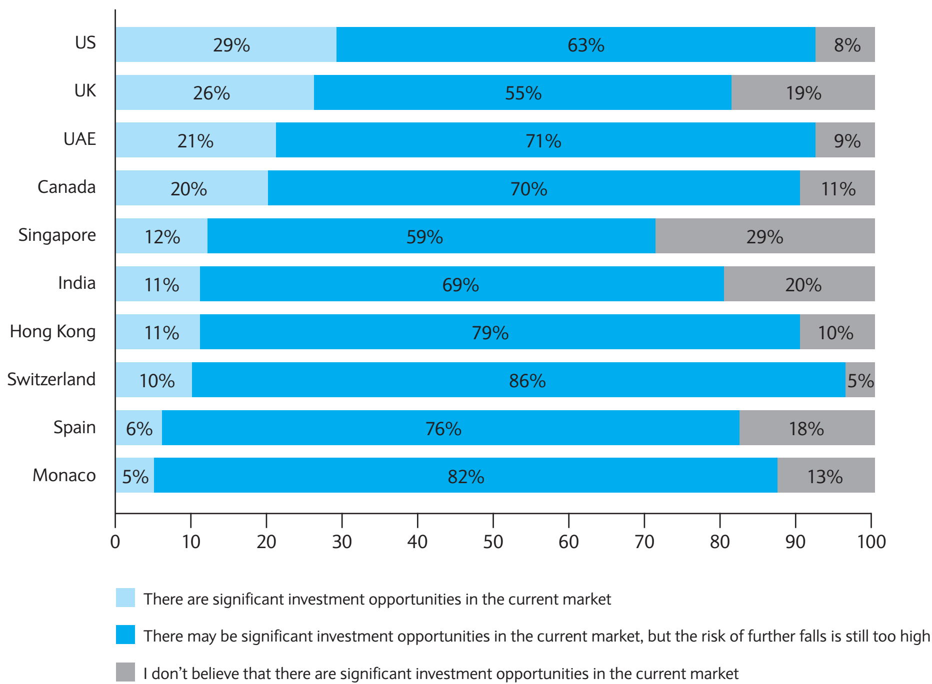
Which of the following statements best characterises your view on current market opportunities?

Graph 1 - Aggregate response from all participants



Which of the following statements best characterises your view on current market opportunities?

Graph 2 - Response by country



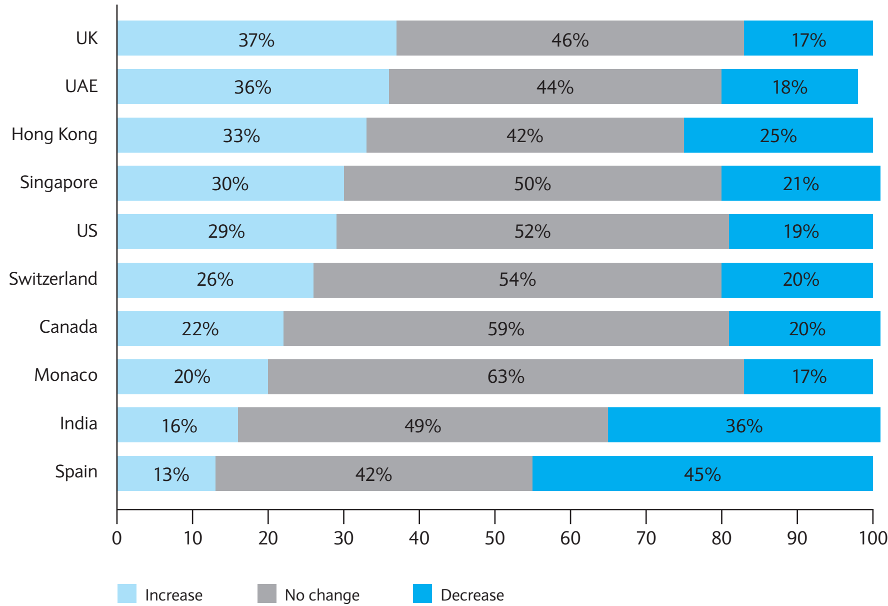
For now, wealthy investors questioned for this survey say that they have little inclination to take on more risk. Just 28 per cent say that they plan to increase the level of risk in their portfolio over the next 12 months, and only 27 per cent plan to increase their willingness to make higher-risk investments. Investors from some countries appear more willing to take on risk than others: for example, 37 per cent of UK investors say that they intend to increase levels of risk in their portfolio, while only 16 per cent of investors from India express the same view. "There is a broad disconnect between investor perceptions that opportunities are out there, and their ability to rationalise what to do about it," says Rory Gilbert, Head of the UK & Ireland Private Bank London Region, at Barclays Wealth. "But if you have a reasonable investment horizon, this is a great time to be starting to add risk at a portfolio level, meaning across a range of asset classes rather than simply picking out very specific opportunities."

> “If you have a reasonable investment horizon, this is a great time to be starting to add risk at a portfolio level, meaning across a range of asset classes rather than simply picking out very specific opportunities.”

Rory Gilbert, Head of UK & Ireland Private Bank London Region, Barclays Wealth

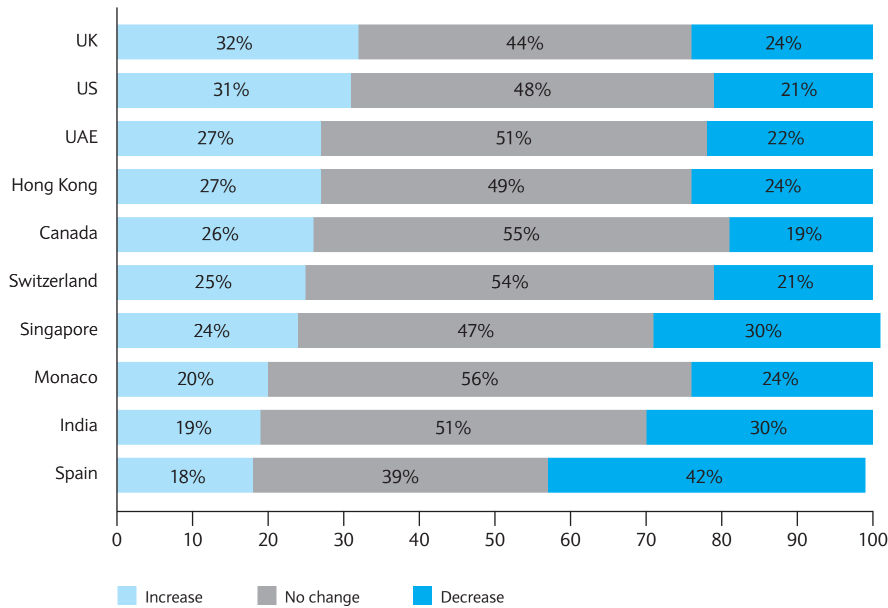
Over the next 12 months, which of the following changes do you expect to make to the following – Level of risk in portfolio?

Graph 3 - By country



Over the next 12 months, which of the following changes do you expect to make to the following – Willingness to make higher-risk investments?

Graph 4 - By country



Perceptions of loss

It is clear that high-net worth investors recognise that the scale of opportunities in the current environment is significant, yet there is a widespread reluctance to dive into the markets. This pervasive aversion to losses among high-net worth investors highlights an important point that goes to the very heart of behavioural finance thinking. In 1979, Daniel Kahneman and his fellow psychologist Amos Tversky published a highly influential paper that suggested that people are much more sensitive to losses than they are to gains of the same magnitude. In general, estimates of the difference in loss and gain perception suggest that losses are felt two to two-and-a-half times as acutely as gains.

The rise of behavioural economics

In the wake of a vertiginous boom and bust in the global economy, searching questions are now being asked about the limits of the efficient markets hypothesis and the effect of human behaviour on market prices. The traditional view holds that the price of a security reflects all known information, and that the individuals who invest in it will carefully weigh up the benefits and costs of a decision, before choosing the course of action that is in their best interests. This concept of a rational, self-interested *homo economicus* has long been at the heart of economic theory.

> "Behavioural biases do play a role at the individual level but I'm a little sceptical about whether they have a strong impact on, for example, prices or long-term market phenomena."

Recent events, however, have added to the weight of evidence that challenges this view, and have led to a surge of interest in the emerging science of behavioural economics. In essence, this means that, rather than assuming that markets are entirely efficient and actors entirely rational, one should pay greater attention to the "animal spirits" – a term that John Maynard Keynes coined to describe the non-economic, non-rational motives of individuals that can cause economies to fluctuate more than should be expected.

Behavioural economics employs our understanding of psychology to explore how human actions can often deviate from the classical rational model. Rather than making self-interested decisions based on a careful assessment of cost and benefit, it suggests that individuals are susceptible to a whole host of cognitive biases and flaws that can influence their actions. For example, they will make decisions based on heuristics, or rules of thumb, rather than as a result of a thorough analysis of costs and benefits and their decisions will be affected by the way in which the situation is presented to them or framed.

But while there is a strong consensus forming around the need to take account of behavioural factors, some commentators advise caution about the degree to which they affect financial markets. "Behavioural biases do play a role at the individual level but I'm a little sceptical about whether they have a strong impact on, for example, prices or long-term market phenomena," says Simon Gervais, Associate Professor at Duke University, The Fuqua School of Business. "That doesn't mean that they don't exist, but my view is that behavioural biases should probably be appealed to almost last when we're trying to explain something that happens in the economy as a whole."

This has important implications in the current environment, when investors' perceptions of their future prospects and willingness to re-enter the markets will be heavily influenced by their recent experiences in financial markets. "It's a common heuristic that people believe that the future will bring the same as has been seen in the recent past," says Brad Barber, Maurice J and Marcia G Gallagher Professor of Finance at the UC Davis Graduate School of Management.

This phenomenon is seen both in rising and falling markets. During a boom, rising markets draw investors along in their slipstream and lead to overconfidence and an underestimation of risk. Then, when markets turn, we see a mirror image in terms of investor behaviour. Risk becomes over-estimated and there is a pervasive lack of confidence. In extreme circumstances, this situation can last for many years. During the Great Depression of the late 1920s and early 1930s, a deep malaise set in that was so pervasive that it took the outbreak of World War II to transform the economy.

"What we see in a boom is a lot of people trading because they seem to think that they have the answer for everything."

"Part of the reason you get bubbles is that when you have a period in which the market goes in a certain direction, people expect it to continue going in the same direction," says Dan Ariely, Alfred P Sloan Professor of Behavioural Economics at Massachusetts Institute for Technology, and author of *Predictably Irrational*. "People tend to extrapolate trends based on the recent past." This means that, when markets are thriving, investors are likely to increase their allocation to booming assets without necessarily considering the fundamentals. Then, on the way down, they will expect a continuation of falling prices and will discount the buying opportunities that a falling market ultimately brings.

"What we see in a boom is a lot of people trading because they seem to think that they have the answer for everything," says Professor Gervais. "They gain confidence over time and that leads them to trade." Perhaps more importantly, investors will start to believe that they would regret it if they do not increase their allocation.

An overcautious approach

One characteristic of a booming market is the so-called 'house money effect'. Just as gamblers at a casino, having enjoyed a winning streak at a table, have a tendency to think that they are playing with the house money rather than their own and so increase their levels of risk, so investors in a bull market will tend to increase their levels of risk because they do not yet consider the profits they have made to be their own. "It's quite easy to take risks when you have been winning," says Daniel Kahneman, Professor of Psychology and Public Affairs, Emeritus at Woodrow Wilson School, Princeton University. "People tend to gamble more when they are doing well."

When boom turns to bust, the mirror image of this phenomenon – what one might term 'the anti-house money effect' – comes into play. Investors will shy away from risk and exercise a high degree of caution, even if there are significant investment opportunities. "When people lose money, it takes a while for their reference points to catch up with their new measure of wealth," says Greg Davies, Head of Behavioural Finance at Barclays Wealth. "They are often in a situation where they are very reluctant to take on new risk and their risk-taking in general decreases."

We can see this changing confidence in data on asset allocation from previous boom and bust periods. In their book *Nudge*, Richard Thaler and Cass Sunstein point to evidence from an investment plan administered by the Vanguard mutual fund company. In 1992, new participants were allocating 58 per cent of their plan to equities. By 2000, at the height of the dotcom boom, this had risen to 74 per cent, reflecting significantly heightened confidence in the performance of equities. Then, two years later, once the bubble had burst, their proportion allocated to equities had fallen to 54 per cent.

Nevertheless, previous downturns have not always brought the same degree of loss aversion. Research by Professor Barber has shown that the weeks following the stock market crash of 1987 saw a higher level of buying by individual investors than at any time in the ten-year period surrounding the crash. The 1987 crash, however, was very different from the current downturn, in that there was a very short and distinct dip, whereas the credit crisis has been characterised by a series of events that have taken place over a period of many months. "I think it's that continuation, over a course of weeks and months, that causes fatigue among investors and a reluctance to 'call the bottom'," explains Professor Barber.

> "If you are reluctant to give up what you have because you do not want to incur losses, then you will turn down trades that you might have otherwise made."

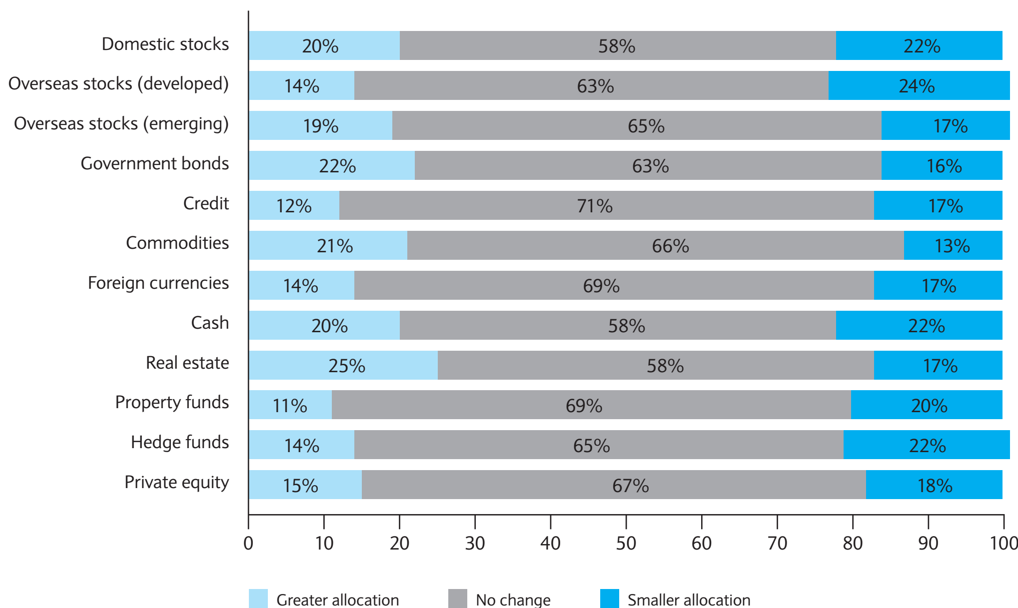
Sticking to their guns

One of the consequences of this sensitivity to loss is that investors become reluctant to make changes to their investment strategy or asset allocation. "Loss aversion helps produce inertia, meaning a strong desire to stick with your current holdings," explain Richard Thaler and Cass Sunstein in their book *Nudge*. "If you are reluctant to give up what you have because you do not want to incur losses, then you will turn down trades that you might have otherwise made."

A notable finding from the survey is the high proportion of investors who, over the next year, plan to make no change at all to their asset allocation. Across every single asset class, more than half of respondents expect to make no adjustment at all – neither increasing nor decreasing their allocation. For example, 58 per cent plan to make no change to their allocation to domestic stocks and 65 per cent do not expect to change their allocation to hedge funds.

Over the next 12 months, what change do you expect to make to your allocation to the following assets?

Graph 5 - All respondents



“The centre of economic, financial and political power is shifting to Asia and US economic dominance will soon be a thing of the past.”

Roy Chen, Director of Sterling Private Management Limited, a Hong Kong-based family office

There are numerous possible explanations for this lack of decisive action. One could be a straightforward fear of confronting a difficult situation. Many people, fearing that they have lost money in the recent turmoil, but being unwilling to accept exactly how much, will simply avoid making the necessary calculations.

Yet given the high degree of volatility and change that continues to be seen in the global economy, this level of inertia may seem surprising. On the assumption that the recent improvement in economic data does herald a recovery in the real economy, a virtuous cycle could set in whereby rising asset prices boost consumer and business sentiment, strengthen balance sheets and restore liquidity to frozen markets. With returns on cash now depressed by ultra-loose monetary policy, and government bonds looking expensive unless the threat of deflation proves real, one might expect investors to respond by moving out of such safe assets in search for yield.

In fact, this does not appear to be the case among the high-net worth investors questioned for this research, many of whom are unwilling to take such decisive action. "One of the responses to a very novel or threatening situation is to freeze," says Professor Kahneman. "This has very deep biological roots – it's what rabbits do and it's what deer do and, to some extent, this is what we all do when we are in the presence of something that we don't understand."

"This has very deep biological roots – it's what rabbits do and it's what deer do and, to some extent, this is what we all do when we are in the presence of something that we don't understand."

At a time when there is still considerable uncertainty about how the financial crisis will resolve itself, many investors seem to have concluded that the best strategy is to stick with the status quo. Part of the reason for this is that investors – with every justification – will find it very difficult to distinguish between a genuine turn in the market and a short-term bear rally. "This uncertainty is causing trepidation," says Professor Barber. "Although there are good investment opportunities, the variance of potential outcomes is still really high."

"If it works and there is a genuine turn in the market, that investor would feel very clever, but they're taking a chance of feeling significant regret if the downturn continues."

This variance causes a fear of regret that will often influence investors to stick with what they have. "At the moment, someone could be very optimistic and invest heavily," explains Professor Kahneman. "If it works and there is a genuine turn in the market, that investor would feel very clever, but they're taking a chance of feeling significant regret if the downturn continues."

A new economy brings a change of focus

Sterling Private Management Limited is a Hong Kong-based family office that manages the assets for members of the Chen family, a prominent Hong Kong family business that was a co-founder of Hang Lung, a publicly listed property company, among other business interests. For most of the past decade, Sterling pursued what was essentially an endowment model approach to managing the family's assets. The goal was wealth preservation with growth, which was interpreted as a global balanced portfolio strategy. But in September 2008, the Sterling directors, with the advice of Grace Financial, which manages the family office's investment operations, decided that a different approach needed to be taken, both in terms of dealing with the crisis on a short-term basis and determining its asset allocation over the longer term.

"In September 2008, we had a very strong sense that the economic crisis was not going to be like previous crashes, not just another boom-and-bust cycle," says Roy Chen, who has been a director of Sterling since its inception in 1993. Central to the change in mindset was a view that, when the global economy does recover, it will do so in a shape and form that few would recognise today. In order to align itself with this new model, Mr Chen says that Sterling will shift its focus from the traditional US and European markets to look primarily at opportunities in Asia.

"We believe we are in the middle of a fundamental change in the balance of power," he explains. "The centre of economic, financial and political power is shifting to Asia and US economic dominance will soon be a thing of the past. Asia today is no longer the volatile, cyclical, boom-and-bust economic environment that it was 15 to 20 years ago."

Mr Chen says that Sterling is already exploring investment opportunities. "There is no doubt that things are cheap and valuations are compelling," he says. "The problem is that not everything will come back up. We are looking at a handful of areas of opportunity, which will also allow us to protect our downside." With a longstanding presence in property, Mr Chen says that Sterling is particularly interested in real estate, but is likely to be highly selective. He also believes that the credit markets look interesting, and that there could be opportunities in commodities, but that timing will be very important.

The key point, according to Mr Chen, is that this approach will help Sterling to weather the downturn and emerge as a stronger proposition. Although, like many family offices, Sterling endured losses in 2008, Mr Chen hopes that the office will be well positioned to take advantage of an upturn in the economy - whatever form this ultimately takes.

The quest for simplicity

Where investors in the survey are changing their asset allocation, the increases tend to be to what might be termed the more straightforward asset classes: cash; real estate; government bonds and domestic stocks. Almost one-quarter say that they plan to increase their allocation to real estate over the next 12 months, while 22 per cent plan to increase allocation to government bonds and 20 per cent to cash and domestic stocks. Elsewhere in the survey, 53 per cent of respondents agree that, in the current environment, they will invest only in what they know.

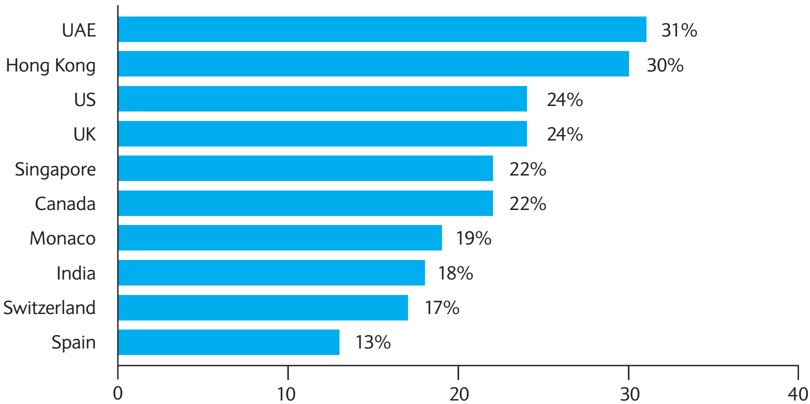
Although approaches will differ from one wealth manager to another, some continue to see the value of a cash cushion. "Our clients' preference for liquidity has gone up dramatically in the past year," explains Carol Pepper, the Founder of Pepper International, a multi-family office based in New York City that manages wealth for several large international families.

"Many wealthy individuals' key priority now is to make sure that they have sufficient liquidity to fund their lifestyle and pay their bills," she says. "You could call it 'your sleep at night' money. With this money secure, you can take more risk with other assets."

The survey reveals regional differences in expected changes to allocation. Respondents from the United Arab Emirates (UAE) are most likely to increase their allocation to real estate, while those from the US are more likely to increase allocation to domestic equities. In the case of the investors from the UAE, one can explain this tendency on the grounds of a strong preference for bricks and mortar investment – despite the scale of the recent property crash in Dubai, one of the Emirates. Meanwhile, the expected increase in allocation to domestic stocks in the US reflects a longstanding faith in the equity culture that may not be as prevalent in other regions.

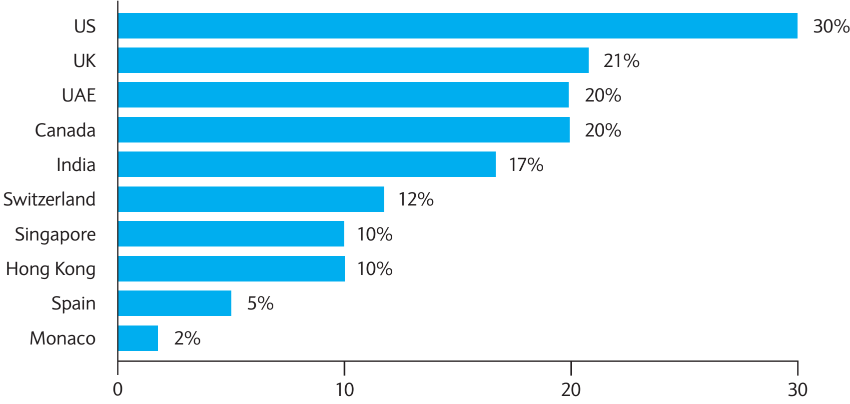
Over the next 12 months, what change do you expect to make to your allocation to the following assets – Allocation to real estate?

Graph 6 - Proportion expecting to increase in next 12 months by country



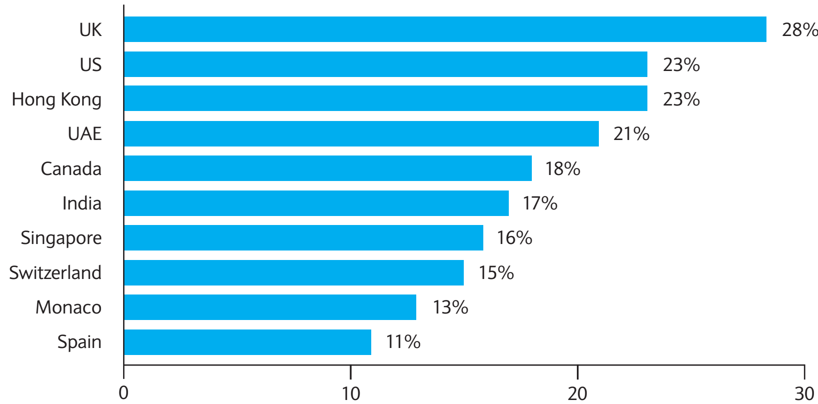
Over the next 12 months, what change do you expect to make to your allocation to the following assets – Allocation to domestic stocks?

Graph 7 - Proportion expecting to increase in next 12 months by country



Over the next 12 months, what change do you expect to make to your allocation to the following assets – Allocation to cash?

Graph 8 - Proportion expecting to increase in next 12 months by country



In general, investors may also prefer passive funds over active because of this desire for perceived stability. But as Mr Davies explains, there is a downside to this kind of retreat into familiarity. "For the people who act now, it is the active managers who will often have the most readily available opportunity to select funds that can add the most value," he explains. Equally, the tendency among some investors to pull back into domestic equities could have the consequence of reducing diversification in their portfolio at a time when this is precisely what is required.

This withdrawal into familiar investment territory is a trend that is characteristic of all downturns. In the current crisis, this phenomenon is likely to be even more prevalent because there is a perception that the problems in financial markets have been caused, in part, by excessive complexity.

What is more surprising, perhaps, is the proportion of survey respondents who plan to increase allocation to cash at this point in the cycle. Although the direction of asset classes such as stocks and bonds over the next 12 months is far from certain, one might wonder why investors are contemplating such a move at a time when most asset classes have already fallen dramatically in price and could, according to some commentators, be nearing a turn in the cycle.

Part of the reason why investors may be continuing to move into cash is related to inertia. It is one thing to feel a loss on paper, but quite another to sell and realise that loss. This reluctance to admit that a loss has been incurred means that there continues to be a trickle of individuals moving into cash despite this being probably a bad time for them to do so.

> "It's very difficult to satisfy both the emotional and the financial factors."

This highlights an important point, namely that investment often involves striking a balance between emotional and financial considerations. High-net worth individuals want their investments to perform well, but they also want to feel comfortable with their choices. "It's very difficult to satisfy both the emotional and the financial factors," says Mr Gilbert, "but I think the key is to have a very clear methodology which, however stressed the market or the investor becomes, remains consistent with the original and continuing objectives of the investor."

Trust and Transparency: a new era of diligence

In the late 1990s and early 2000s, there was a widely held assumption that macroeconomic policy had reached an unprecedented level of maturity. High-profile economists trumpeted the "death of inflation" while politicians proclaimed an end to boom and bust. Some commentators spoke of a "great moderation" whereby it was suggested that a long-term decline in the volatility of major economic variables had been achieved.

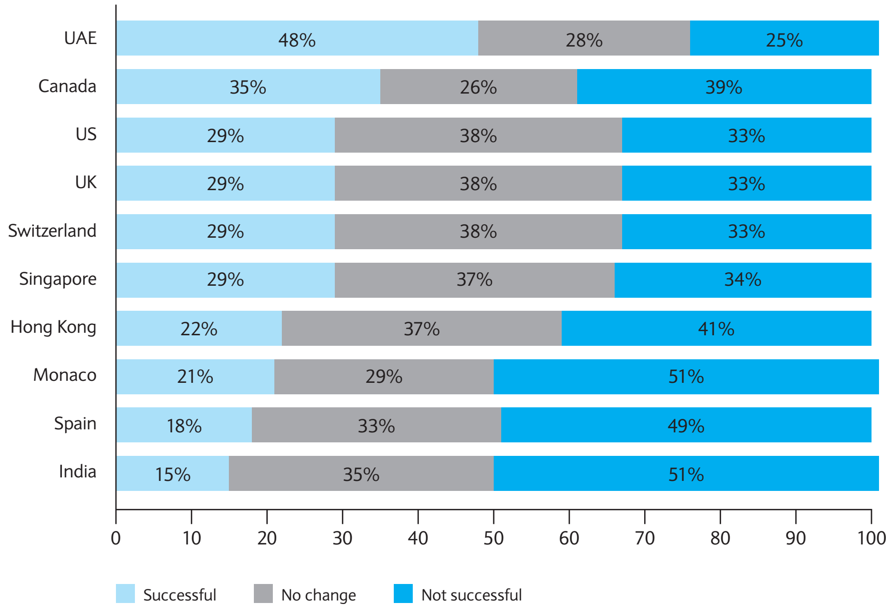
Ten years on and this picture has been revealed to be woefully optimistic. Economic pain, reflected in millions of lost jobs and destroyed savings, has entered the political realm, causing some governments to collapse and threatening others. Dennis Blair, America's new intelligence chief, says that political turmoil from the global recession has replaced terrorism as the country's biggest security threat. In countries around the world, searching questions are being asked about the effectiveness of major political, economic and financial institutions. To what extent did they fan the flames of the crisis and how successful were their attempts to bring the conflagration under control?

It is clear from the survey that there has been a massive erosion of trust in major institutions. Only a minority of high-net worth investors believes that governments, central banks, and the media have handled the crisis well, suggesting that there is a crisis of confidence among the broader population that will take significant political and policy intervention to resolve.

The misgivings of investors differ from one country to the next. Out of the 10 countries for which more than 100 respondents took the survey, investors from India are most scathing about the performance of policy-makers, despite their region being, relatively speaking, less severely affected by the financial crisis. Just 11 per cent of respondents from India say that the handling of the crisis by their domestic government has been successful and just 15 per cent rate the handling by their central bank as effective.

How would you rate the handling of the financial/economic crisis by the following institutions – Central bank in your region?

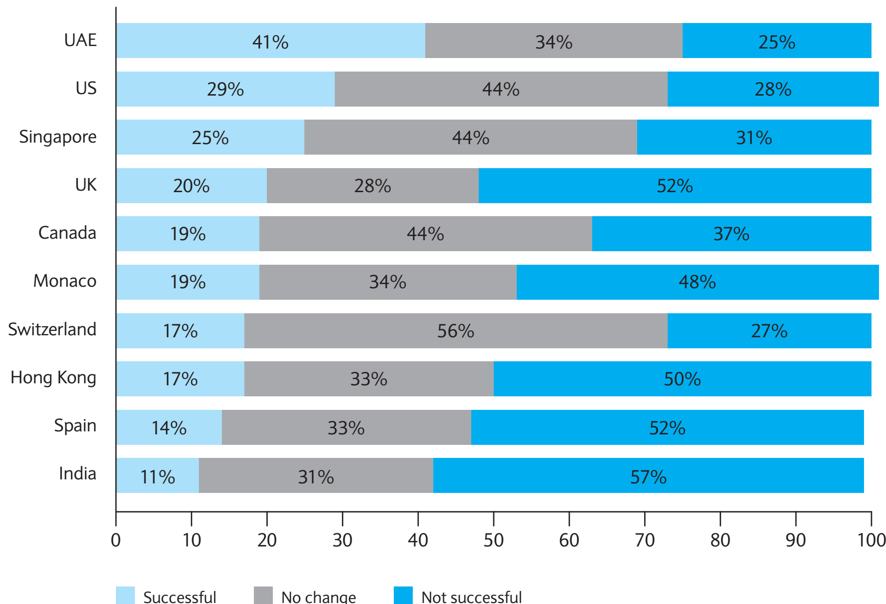
Graph 9 - Responses by country



Across Asia, there are significant differences between the ability of central banks to formulate a response. Consider, for example, the difference between China and Japan. "China has the capacity to ride out the crisis because it's a surplus country," says Kenneth Kuttner, Professor of Economics at Williams College. "While in Japan, they would like to spend more on fiscal stimulus but first, they are facing a declining population and this is going to lead to an unsustainable fiscal balance, and second, it is more difficult to spend on infrastructure in Japan in a productive way, because the country already has such a high level of public capital."

How would you rate the handling of the financial/economic crisis by the following institutions – Government in your domestic market?

Graph 10 - Responses by country



Investors from Europe also have few positive words to say about policy-makers, with just 29 per cent of respondents from the UK rating the handling of the crisis by the Bank of England as successful, and just 18 per cent of Spanish respondents rating the performance of their central bank highly.

> “Businesses in Europe are much more dependent on the banking system than in the US and that limits the room for manoeuvre that the central bank has.”

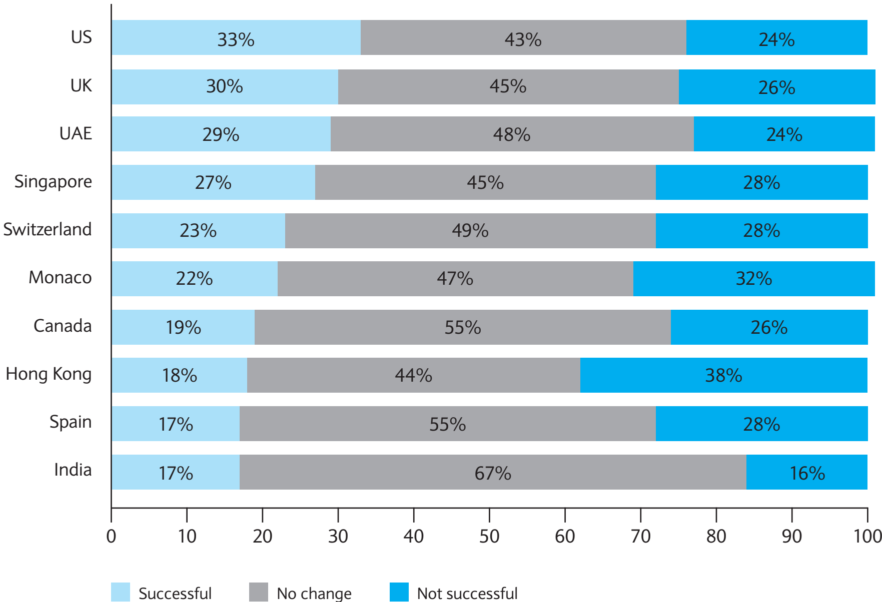
In recent months, there has been criticism of the European Central Bank for the sluggishness of its response to the economic crisis, but the ECB also suffers from constraints that can hamper preventative action. “There are limitations to what the ECB can do, even though they are looking at some instruments going beyond the interest rate,” says Mr Van Ark. “Businesses in Europe are much more dependent on the banking system than in the US, and that limits the room for manoeuvre that the central bank has.”

Among the 10 countries that were most heavily represented in the survey, respondents from the UAE are least critical of the handling of the crisis by policy-makers, with 48 per cent of respondents rating their central bank as successful in its actions to stem the crisis. “Central banks and governments in the Gulf region did all that one could have hoped to respond to the crisis,” says Florence Eid, Managing Director for the Middle East and North Africa at Passport Capital, a global investment firm. “For example, the Government in the UAE undertook quite a bold move early on to guarantee all deposits in all banks. They also recapitalised the banks and extended liquidity facilities in a move that was followed by the Saudi central bank.”

One interesting finding from the survey relates to the perceived degree of success that the new Obama administration has had in managing the economic crisis. For the 10 countries in the survey for which there were more than 100 respondents, there was no single country in which more than one-third thought that the Obama administration’s handling of the crisis had been successful. Even in the US, where President Obama continues to enjoy approval ratings of around 60 per cent, this figure among the wealthy investors in our survey rises only to 33 per cent.

How would you rate the handling of the financial/economic crisis by the following institutions – Obama administration in US?

Graph 11 - Responses by country

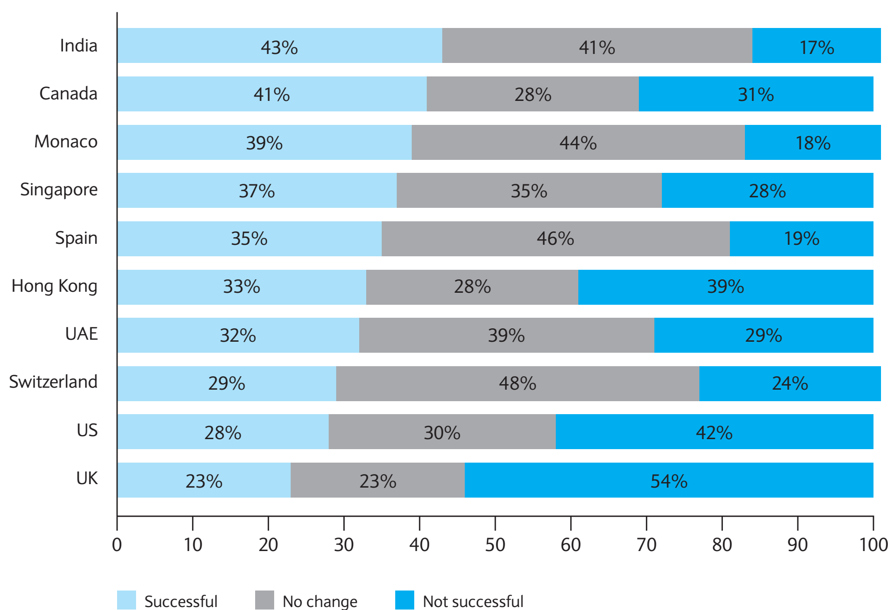


The role of the media also comes under fire from the survey respondents. Just 30 per cent say that the media has been successful in its reporting of the situation, while 33 per cent of respondents rate it as unsuccessful. Respondents from the UK and US are particularly scathing about the handling of the crisis by the media, while those from India and Canada offer the least negative assessment.

This reflects criticism, which has been particularly prevalent in both the US and UK, that the media can tend towards one-dimensional sensationalism in order to generate sales. Many commentators have suggested that, during a bull market, the media is only interested in building up a good news story about rising asset prices and then, during a downturn, it seeks only to publish headlines about crisis, panic and loss.

How would you rate the handling of the financial/economic crisis by the following institutions – Media?

Graph 12 - Responses by country



In an opinion piece in his own newspaper, *Financial Times* Editor Lionel Barber described how, in the build-up to the crisis, reporters who covered credit markets and the shadow banking system "found it hard to interest their superiors who controlled space and who were more interested in broadcasting the 'good news' story of rising property prices and economic growth." Writing in the *British Journalism Review*, the investigative journalist Danny Schechter goes further, arguing that some news outlets were reluctant to publish bad news stories related to the sub-prime crisis because they feared that this would alienate key advertising accounts in the property industry.

These are legitimate areas for enquiry, but one should also not ignore a positive outcome from the crisis. Business and financial stories, once confined to a media backwater, have taken centre stage and financial journalists have become among the highest-profile in the profession. With finance firmly in the mainstream media, one can only hope that, when the next crisis comes around, journalists will be more knowledgeable, sceptical and willing to expose the warning signals than they were before the current crisis.

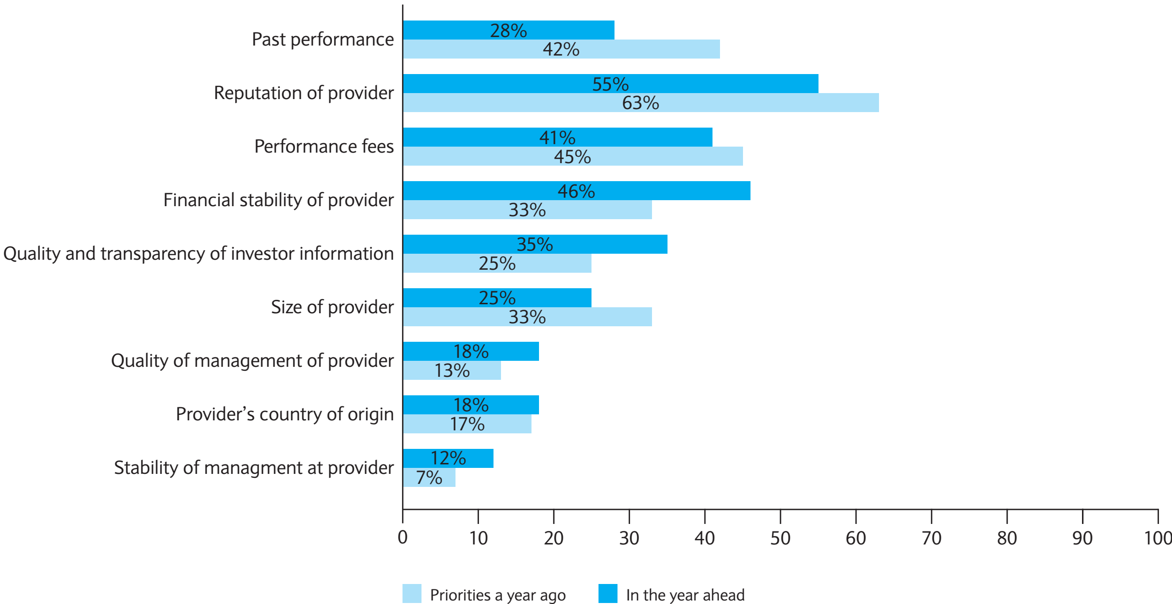
Transparency and due diligence

This erosion of trust is having broader implications on the behaviour of high-net worth investors, with increasing numbers becoming more circumspect about the way in which they select a financial provider, such as a fund manager. First and foremost, high-net worth individuals questioned for this research are applying more care to the selection process. Whereas during a boom, they would have focused on past performance and paid less attention to other criteria, today they are taking account of a broader range of factors. The quality and transparency of investor information and the financial stability of the provider, are rising up the agenda, while past performance and fees are becoming less of a consideration.

"I think there has to be more transparency on what fees are, and a lot more understanding of the risks of different products," says Ms Pepper. "Investors also need to realise that all investment involves risk and understand that you have to pay for the returns that you get. And we need a lot more plainly written, understandable disclosure of what products are and how they work: that is critical."

When selecting an investment from a provider, such as a fund manager, which of the following criteria were/will be most important to you?

Graph 13 - Aggregate response from all participants

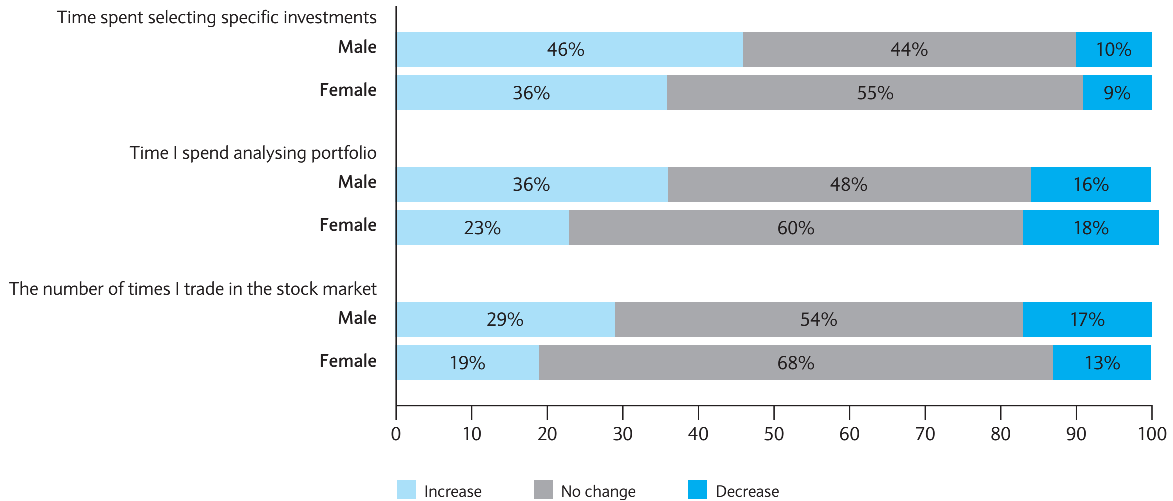


It is also notable that a high proportion of investors are increasing the time they spend before selecting a provider. Almost half of respondents say that they plan to increase the amount of time that they spend on selecting investments, while one-third of respondents plan to increase the time they spend analysing their portfolio. In this respect, there are interesting differences between the genders. Male respondents are, in general, more likely to increase the time they spend both on selecting investments and analysing their portfolio. They are also more likely to increase their frequency of trading.

> "I think there has to be more transparency on what fees are, for example, and a lot more understanding of the risks of different products."

Over the next 12 months, which of the following changes do you expect to make to the following?

Graph 14 - Responses by gender



A longer-term perspective

The current financial and economic crisis has changed the way that investors view their investments, according to Guillaume Taylor, a Partner at de Pury Pictet Turrettini & Co. Ltd. (PPT), an independent financial wealth management firm based in Geneva. “Investors today are looking at performance over a much shorter time frame, and are much more concerned about liquidity,” he says. “These are aspects that we need to take into account when structuring portfolios currently."

Like many, Mr Taylor believes that investor confidence has been badly hit by recent events. “Investors want to have more transparency and better understand what they’re investing in, and they want to have a much closer emotional tie to their portfolio,” he says. In response to this need, Mr Taylor notes that PPT, which has around US$3bn under management, is paying a lot of attention to how it communicates with investors to make sure that they have a full understanding of the underlying risks across different asset classes.

Mr Taylor is a strong believer in responsible investment. “Investors need to understand the notion of ownership,” he says. “When you buy a stock, you are part owner of a company, so you should be investing because you believe in the firm and in its potential and its impact on sustainability issues. It’s not just about financial returns. And to do this, you need a longer-term perspective.”

He believes that there are now plenty of investment opportunities available, and notes that some investors are already starting to invest again. “There are a lot of opportunities around, including outside of mainstream investing. Investors need to move away from this notion that the market is only about blue chip stocks.”

The company is also paying a lot of attention to international investment opportunities, particularly in emerging markets. “We think that large developed markets currently trade at attractive valuations, but their economies offer limited growth potential,” he says. “Emerging markets on the other hand offer significant opportunities in terms of growth.”

Conclusion

This report has focused primarily on the ways in which human behaviour can affect investment decision-making. At a time when the global economy shows some signs of stabilising, but when investors continue to face situations that they find difficult to interpret, it is all the more important to see through the fog of irrational behaviour and understand how it can adversely impact future prospects.

Much of the popular discussion on irrational behaviour in financial markets focuses on the circumstances that lead to asset price booms. We are, rightly, fascinated by why investors will place exorbitant values on tulip bulbs or shaky dotcom companies – and then make these mistakes time and again. What gets discussed less widely is how there is a mirror image of 'irrational exuberance' during a downturn, when investors can overestimate, rather than underestimate, risk and let their recent experience of falling markets cloud their assessment of future opportunities. Just as during a boom, investors can mistakenly extrapolate a trend of rising prices, so in a downturn they can expect a continuation of falling prices – only to delay re-entering the market and find that they have missed the turn in the cycle.

Volatile financial markets can encourage a short-term time horizon, with investors focusing on daily or weekly price movements and losing sight of their longer-term objectives. For most high-net worth investors, it is not what happens over the next month that is important, but what happens over the next five, 10 or 20 years. With an appropriate time horizon in mind, short-term fluctuations in market prices become less important and the real value of investment opportunities can be more objectively assessed.

Recent academic thinking on behavioural finance is providing a much clearer picture of how human psychology can affect investment decision-making, particularly at times of great volatility. As this paper makes clear, irrational, herd-like behaviour is as evident at the nadir of the bust as during the excesses of the boom. This is not to say that people are wrong to be fearful or risk averse in the current climate. But the ability to disentangle the complex mixture of emotional and objective factors that drive decision-making is as important to investors seeking to optimise their portfolios as it is to students of financial crises.

Methodology

Written by the Economist Intelligence Unit on behalf of Barclays Wealth, the report examines the behaviour and characteristics of high-net worth investors in an uncertain economic environment.

It is based on two main strands of research: a global survey of more than 2,100 mass affluent (with up to US$1.5 million in investable assets), high-net worth (with up to US$15 million in investable assets) and ultra high-net worth individuals (with up to and in excess of US$45 million in investable assets) and a series of in-depth interviews with economists, business leaders and behavioural finance experts.

Please note that in some cases, percentages used in the report may not equal 100, either because survey participants were asked to select multiple choices or because neutral or "don't know" responses have not been included.

Survey demographic

The 2,100 respondents were recruited from Economist Intelligence Unit databases of individuals around the world. The survey was undertaken by the EIU between March and May 2009.

Geography: Canada, the United Arab Emirates, Hong Kong, India, Monaco, Singapore, Spain, Switzerland, the United Kingdom and United States were each represented by more than 100 respondents. Additional respondents were generated from elsewhere in the world (30 per cent North America; 30 per cent Europe; 30 per cent Asia-Pacific; and 10 per cent Middle East, Africa and Latin America).

Net worth: 40 per cent between US$750,000 and US$1.5 million in investable assets; 40 per cent between US$1.5 million and US$15 million; 10 per cent between US$15 million and US$45 million; and 10 per cent in excess of US$45 million.

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