CAPCO

AVOIDING THE LOWS IN A HIGH INTEREST RATE ENVIRONMENT

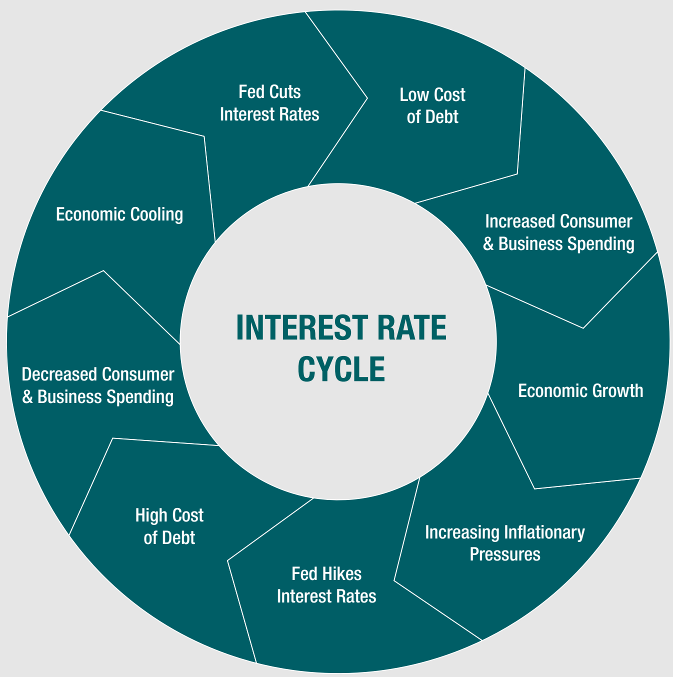
CONSIDERATIONS FOR WEALTH MANAGEMENT FIRMS

a wipro company

Following a prolonged period of low interest rates, the Fed has begun implementing sharp interest rate hikes to cool the economy and combat high inflation. How can wealth managers navigate the high interest rate environment and find opportunities for growth?

The Fed Funds Rate, the interest rate at which banks and other depository institutions lend money to each other, has been increased by 0.75% for the second straight quarter to a range of 2.25% - 2.50%.[1] The Fed has also forecasted that the Fed Funds Rate will continue to be increased through 2022 to end the year at 3.25% - 3.50%[1]. By increasing the Fed Funds Rate, the Fed indirectly increases borrowing rates for businesses and consumers.[2] This results in less borrowing, which in turn reduces spending, cools down the economy and slows down inflation.[1]

While high interest rates have widespread implications across industries, wealth managers tend to feel their effects immediately and in a variety of ways across their service offerings. Examples include higher interest rates offered on cash deposits, higher mortgage rates, and negative implications for client portfolios due to the generally inverse relationship between interest rates and stock prices.[3] It is important that wealth managers understand the implications of high interest rates across their business segments and strategically position themselves to navigate this **interest rate cycle.**



POTENTIAL HEADWINDS FOR MASS MARKET

Wealth managers will experience widespread challenges due to higher interest rates and the resulting down-market. We expect to see these implications play out across client segments including mass market, mass affluent, high-net-worth, and ultra-high-net-worth. Wealth managers that have been leading with robust financial planning and a focus on long-term goals-based planning are poised to have higher client retention rates versus those that are solely focused on investment performance.[4] While financial planning services are commonplace within the wealthier client segments, they are not as prevalent with mass market clients.

Robo-advice is a trending area of wealth management that provides diversified investment portfolios to mass market clients based on an upfront survey about their financial situation. Robo-advice has gained significant traction over the past several years, growing from $30B in assets under management (AUM) in 2017 to $1.43T in 2021.[5] During this same period, the S&P 500 has averaged annual returns of over 17%.[6] The question for wealth managers becomes whether the increase in AUM over the past five years is tied to outsized performance and whether investors intend to weather the volatility. With rising interest rates putting pressure on the stock market, this is the first time that portfolios managed by robo-advisors are facing the possibility of prolonged economic headwinds. Furthermore, behavioral finance suggests that investors tend to be loss aversive, meaning that they dislike losses more than they enjoy gains.[7] This could result in outflows for wealth managers that are not adequately equipped to address shifting client goals in an otherwise hands-off robo-advice industry.

Another consideration within robo-advisory is the average account balance per user and its implications on asset retention. Despite the impressive stock market performance over the past 5 years, the average AUM per user declined from $6,950 to $4,720.5 This implies that robo-advisors scaled by bringing on clients with smaller balances. During a recessionary environment, these clients may exhibit a higher rate of asset turnover due to higher inflation, unemployment, or more expensive debt obligations that effect their ability to fund lifestyle needs. Wealth managers should consider the implications of inflation and higher interest rates on this rapidly growing segment of their business and refine their strategies accordingly.

We have learned from traditional wealth management that goals-based planning has led to stickier client relationships. Many robo-advisors, such as Wealthfront and Betterment, are already offering investors digital goals-based planning tools as part of their offering. As we continue to navigate this high interest rate environment, wealth managers should offer goals-based planning tools to their mass market clients and closely track engagement with these tools. As clients share their goals with wealth managers, it is critical that automated robo-advisory portfolios are systematically realigned to these updated goals.

CLIENT ENGAGEMENT OPPORTUNITIES FOR HNW

In the high-net-worth segments of wealth management, the implications of inflation and high interest rates vary across services such as traditional investments, alternative investments, lending, and estate planning. In many cases, a high interest rate environment may give advisors an opportunity to be strategic around their clients' financial planning needs and strengthen their relationships with clients.

After many years of strong annual returns, high interest rates have caused asset prices across traditional investments to depreciate, with the S&P 500 down over 21% in the first half of 2022. While clients' core portfolios may have depreciated in value, volatile markets can provide compelling investment opportunities across traditional investments and alternatives.[8] For example, some hedge funds may offer returns that are uncorrelated with the market and distressed private investment funds can position to take advantage of depreciated debt investing.[9] Advisors should use this opportunity to revisit their clients' portfolios and determine if any investment strategy changes are appropriate based on their goals-based plans. For example, an advisor may consider de-risking equity heavy portfolios that are aligned to upcoming client goals or using the recent dip in markets to add equity exposure for clients with longer-term objectives.

Outside of investments, many wealth managers also provide lending solutions such as lines of credit, mortgages, or margin loans. Higher interest rates will increase the cost of floating debt obligations and the prevalence of margin calls due to depreciated asset prices. Advisors should be transparent about upcoming changes in their client's interest expense and potential margin calls to collaborate on solutions ahead of time. For example, advisors may be able to work with their lending teams to fix a portion of their clients' floating debt to provide more certainty around future debt expense.

One area of wealth management that may help clients take advantage of higher interest rates is estate planning. Gifting strategies such as Qualified Personal Residence Trusts (QPRT) and Charitable Remainder Annuity Trusts (CRT) may benefit from increases in the 7520 rate.[10] For example, a client looking to gift their personal residence to their children, may consider utilizing a QPRT, which would allow them to gift the residence today and continue to reside in it during their lifetime. "The initial transfer to the QPRT is a taxable gift of the value of the remainder interest, calculated using the §7520 rate. The higher the rate, the higher the value of the grantor's right to use the residence as his or her own during the term of years, and the lower the value of the gift of the future remainder interest."[10] During periods of high interest rates, advisors can add value by working with their clients' estate planning attorneys to determine appropriate recommendations.

CONCLUSION

After a prolonged period of low interest rates, the Fed's recent interest rate hikes have shocked the markets. Wealth management is a wide-reaching industry that feels the effects of high interest rates across their client segments. Robo-advice is a relatively new area of wealth management that has benefited from strong growth over the past five years during a period of market strength. As interest rates rise and markets begin to dip, robo-advisors will face their first prolonged period of economic headwinds. Wealth managers that offer robust digital goals-based planning services to their robo-advice clients and ensure portfolios are closely aligned with goals will be better positioned to retain assets. Within traditional wealth management the effect of higher interest rates varies greatly across investments, lending, and estate planning. While clients' core portfolios may be down, higher interest rates may provide opportunities to engage clients with ancillary strategies that may result in positive outcomes. Across client segments, wealth managers will find success by understanding the shifting economic landscape and seizing opportunities to strengthen client relationships.

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Capco, a Wipro company, is a global technology and management consultancy specializing in driving digital transformation in the financial services industry. With a growing client portfolio comprising of over 100 global organizations, Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to deliver end-to-end data-driven solutions and fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its Innovation Labs and award-winning Be Yourself At Work culture and diverse talent.

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