There's a headwind blowing

Macroeconomic upheaval is changing the business of private banks

Interview with Prof. Dr. Klaus W. Wellershoff, Chief Executive Officer, Chairman of the Board of Directors and Partner at Wellershoff & Partners Ltd.

After a very tough decade which saw extensive changes around banking secrecy, the US tax program, tax transparency, negative interest rates and squeezed margins, the Swiss financial center and Swiss private banks have enjoyed several successful years. In an interview with Prof. Dr. Klaus W. Wellershoff, Chairman of the Board of Directors of Wellershoff & Partners and chief economist for 12 years at Swiss Bank Corporation and UBS, we explore the role played by central bank policy and how private banks in Switzerland must adjust to a new reality of rising interest rates, inflation and a possible recession.

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About Prof. Dr. Klaus Wellershoff

Klaus W. Wellershoff is Chairman of the Board of Wellershoff & Partners and was previously chief economist, first of Swiss Bank Corporation and then of UBS, for 12 years. He teaches economics at the University of St.Gallen and serves on the board of trustees or board of directors for organizations in the fields of science, culture and sport.

Christian Hintermann We have experienced many years of expansionary monetary policy, during which private banks in Switzerland were able to benefit from booming stock markets. How will we look back on this period in the future?

Prof. Dr. Klaus W. Wellershoff The decline in interest rates over the last few years was the major reason the asset management industry reached such great heights. Most assets under management are valued based on the present value of their expected future cash flows, and when interest rates fall, the various asset classes – whether real estate, equities or bonds – are simply worth more. This tailwind of falling interest rates, which we've actually been experiencing since the early 1980s, will no longer exist in the future. Instead, we face a headwind for the time being.

Would you say the boom phase of asset prices covered a period beyond just the past ten years?

Yes, exactly, it's a long-term trend and you can put it into concrete figures. Financial assets have increased in value by around six times more than the economy has grown over the last 40 years – simply because of falling interest rates.

The banking industry – and private banking in particular – has been one of the big beneficiaries of this development, of course.

That is correct. Assets under management have grown not only because of increasing wealth in the world, but also because they're valued much higher than before. In such a development, the business model of being compensated based on a percentage of assets under management is, of course, ingenious.

The geopolitical and macroeconomic environment has changed dramatically in recent months against a background of high inflation, rising interest rates, the threat of recession, war in Europe, supply chains problems and uncertainty in the energy supply. We are facing upheaval – with major implications for the asset management industry.

I see two phases of development ahead of us. One is the search for the right level of interest rates and asset prices. Interest rates will definitely be higher than they are today. In the long term, the interest on debt capital must at least correspond to the rate of inflation, and we're far from that being the case today. It means interest rates will certainly be corrected upwards even further. Moreover, we're left with the question of where the inflation rate will settle. Things will go on from this point, but without a tailwind. This will put enormous selection pressure on the asset management industry. We will see many more years of negative performance. Not everything you buy automatically goes up in value anymore.

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Are we talking more about a soft or a hard landing?

Once the first phase of creating a new balance is over, the challenges will be huge. We have already lost around 20 percent of global financial assets as of mid-year, and we’re not yet even done with the adjustments. This new macroeconomic scenario is forcing banks, insurance companies and pension funds to rethink their business models. At the same time, confidence in these large institutional financial intermediaries continues to dwindle. So, for some it will end up being a hard landing.

What will happen in the second phase, once the interest rate and asset price levels have settled down?

The realignment of interest rates and asset price levels will be followed by the second and much more exciting phase. The way we invest assets will change, and so will the technology we use in the process. The traditional portfolio theory of investment dates back to the 1960s and 1970s. This approach may have still proved its worth in the 1980s and 1990s. Viewed rationally, though, the recommendations we’ve been hearing for years do not stand up to empirical scrutiny at all. Customer dissatisfaction will take on a whole new dimension.

In your view, what timeframe are we looking at for this macroeconomic adjustment process? Will we see a recession? How long could it take for a recovery?

The recession is very likely the lesser evil. The big question is how quickly we will manage to reduce the enormous debt created in recent years or convert it into other forms of legal entitlements. The longer we refuse to recognize that we overdid it, the longer it will take to make a fresh start.

In this new environment, will performance become even more established as a differentiator in the private banking and asset management industry?

You cannot stand out in the market with a positive performance, but you can certainly come off badly with a poor one. Or to put it another way: brushing your teeth thoroughly does not increase your chances of finding a partner, but poor dental hygiene will quickly make you less attractive.

Where do you see opportunities for providers to differentiate themselves from the competition?

The banking world has spent the last 30 years developing and advancing its technologies, compliance and distribution structures. Digitalization of banking is the latest stage of this journey. But little thought has been given to the content that is sold to clients. Those who produce without considering the real needs of their customers are in danger of losing their competitive position. And this is precisely where pressure will grow. From the client’s point of view, the banks and their services are all the same. A large portion of the advice provided by banks can also be provided by non-banks. So banks will have to work on their willingness to change, otherwise they risk losing a lot of added value. The traditional banks are often too static and too spoilt by their past success.

Are you questioning digitalization?

No, not at all. Digitalization is great, useful and necessary. What I want to say is that when a bank’s IT specialists and data analysts develop new tools and tap into new data, they do so with the idea of creating the most profitable business model for the bank. However, they rarely give a thought to how they can improve customer satisfaction. They simply don’t know enough about this, and often the bankers don’t either.

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Opportunities are emerging now – as we speak. And those who aren’t looking will miss them.

What does the client really want? Your analyses repeatedly reveal striking differences in the performance that asset managers and private banks achieve for their clients. Where do these big differences come from if asset management as a product is so interchangeable and has such little scope for differentiation?

I would like to put the term performance into context a bit and get some perspective on its meaning. Clients are not simply looking for performance from their bank or asset manager. First and foremost, they want someone to look after them. Clients are after a sounding board, someone who explains to them what is possible and what is not, someone to give a second opinion. The performance has to be right, of course, but it is not the first priority. Interestingly, we find a correlation between private banks’ corporate culture and their performance. Banks that are open-minded and genuinely interested in the world and their clients often also perform better. Related to this is an issue that the younger generation in particular will be observing keenly in the future: the conflict of interests between what is beneficial to me and my assets, and what is primarily beneficial to my bank. This issue is becoming more accentuated due to increasing transparency, digitalization and better informed clients who take an active interest. Here again, we find that the banks with a professional approach to the issue often also achieve better investment results.

For the younger generation of clients, sustainable investment opportunities are a key topic in asset management. How disruptive will ESG be for the global economy and the financial industry?

The sustainability issue is not new. When I joined Swiss Bank Corporation in 1995, we were the largest provider of Eco-Performance equity funds; that’s what it was called back then. Environmental and ethical issues have always played a part in this. However, we deliberately avoided really actively communicating this to the outside world and to our clients because the client advisors in particular were not yet ready to discuss the topic with clients. And clients probably weren’t ready either. Today, everyone is aware of ESG, but it is still too emotionally charged and shouldn’t be offered with too many promises. I don’t think the topic will trigger major structural change. For most banks, an ESG focus must be integrated into the investment process. We advocate doing this with a sense of proportion and leaving the extreme solutions to specialists.

In past global crises, Switzerland has benefited from its neutrality. Now the country has adjusted its previous position on neutrality to a certain extent. How will this new stance affect the financial center?

The past attitude of evading transparency and the rules of an international capital market under the guise of independence and neutrality is, of course, no longer possible today. Those days are gone. But the Swiss financial center does have certain qualities that it can use to outdo other financial centers and countries. Private banking in Switzerland offers positive aspects such as tradition, experience, know-how, specialized services and the high level of training of bank employees.

Is it even possible to make reliable forecasts today given the high level of interconnectivity and the massive upheaval we’re seeing in politics, the global economy and monetary policy?

Yes, very much so. Much in life is determined by chance, but there are major correlations that occur with a high degree of reliability. If a currency is clearly undervalued or an interest rate level is clearly too low, then the greater the imbalances, the stronger the effect of these macroeconomic mechanisms will be. We know a great deal and very precisely how things are going today, but many do not want to admit it because it forces us to make changes. However, those who face the situation with entrepreneurial ambition can look forward to great opportunities for the next 20 years. These opportunities are emerging now – as we speak. And those who aren’t looking will miss them.


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