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Should your bank invest for you? Evidence from private banking accounts☆

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ABSTRACT

We analyze a large dataset of private banking portfolios in Switzerland of a major bank with the unique feature that parts of the portfolios were managed by the bank, parts were advisory portfolios. To correct the heterogeneity of individual investors, we apply a mixture model and a cluster analysis. Our results suggest that there is indeed a substantial group of advised individual investors that outperforms the bank-managed portfolios, at least after fees. However, a simple passive strategy that invests in the MSCI World and a risk-free asset significantly outperforms both the better advisory and the bank-managed portfolios.

1. Introduction

In this article we want to study whether it is worthwhile for individual investors to entrust their money to a portfolio manager of a private bank (discretionary account), or whether it would be sufficient to obtain well-informed investment advice from the bank (advisory account).[1] Individual investors are known to be prone to suboptimal investments. Much research has been done on this topic, particularly on the comparison with institutional investors, who usually do more research when making investment decision, often have a larger search set of assets for purchase and sale, and devote more time to searching. Individual investors typically lack either discipline or professional knowledge. They may be overconfident and are more likely to be influenced by attention and news. This paper studies the performance of individual investors in an advisory context – that is, with the assistance of an advisory service provided by a bank – and compares their investment performances with the performances of bank managed portfolios. In such a situation, individual investors to some extent share the same information and knowledge as the bank providing the advice. We try to identify in this case, whether institutional investors outperform individual investors.

The performance and the behavior of individual investors are well surveyed in Barber and Odean (2013): (1) The aggregate performance of individual investors is poor. On average, they cannot beat the market, indicating that they might also be outperformed by other types of investors, such as the institutional ones. Furthermore, there is tremendous variation in the cross-sectional performance of individual investors, traced to gender, age, investment style, etc. (2) Explanations in the literature for the poor performance of individual investors are informational disadvantage on the one hand; on the other hand, behavioral reasons such as overconfidence, sensation seeking and familiarity

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[1] We would like to point out that, although one of the authors' affiliation might suggest it, the bank studied in this article is *not* the UBS.

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are also proposed. (3) Some behaviors of individual investors, for example, underdiversification and disposition effect, are hard to reconcile with modern economics, where agents are assumed to be rational.

Given these characteristics of individual investors, the need and the benefit of financial advisors are widely discussed in the literature. Allen (2001) points out that financial institutions create an agency problem, where the investment decision makers do not necessarily own the assets. On the theoretical side, Krausz and Paroush (2002) model financial advisors' behavior when facing a conflict of interest between themselves and investors paying for both financial advice and execution as a joint product. Inderst and Ottaviani (2009) analyze the inherent conflict between the task of prospecting for customers and the task of advising for the needs of the customers when searching for suitable products. Nicola et al. (2015) model investors delegating portfolio management to professionals based on trust. They find that investors prefer to hire managers, even though managers on average underperform the market net of fees.

On the empirical side, Bergstresser et al. (2009) study broker-sold and direct-sold funds from 1996 to 2004 and find no substantial tangible benefits delivered by brokers. Moreover, broker-sold funds have lower risk-adjusted performance than direct-sold funds, even before fees, and funds with higher fees are sold more. Kramer (2009) finds no evidence of significant out- or underperformance of advised investors in comparison with self-directed investors. Hackethal et al. (2011) find that advised portfolios deliver lower net return and lower risk-adjusted performance than self-managed portfolios on average and this phenomenon is stronger with bank advisors than with independent financial advisors. Bhattacharya et al. (2011) study the case of unbiased financial advices. They find that the portfolio efficiency of investors following the advice increases, but that financial advice is hardly followed by those who receive it and thus that advised portfolios on average show no improvement of efficiency. They conclude that unbiased financial advice is a necessary but not sufficient condition for individual investors' benefit. Cici et al. (2014) provide evidences that investors benefit from financial advisors by valuable tax-management advices. Bachmann and Hens (2015) find that investment competence is positively related to demand for financial advice, i.e., investors most likely to make investment mistakes are those who the least likely to seek financial advices. Hoechle et al. (2016) document that advisors hurt trading performance but help reduce some behavioral biases of the individual investors.

Most of the empirical literature up to now has only compared advised investors with independent investors. In this paper, we analyze portfolios of clients from the private banking department of a large bank. They are either advised portfolios or bank-managed portfolios. Under this setup, the same bank is the financial advisor for one client, and at the same time the portfolio manager—thus the final decision maker, for another client. Given the mixed conclusion for the role of financial advisors in the literature, this paper carries out the discussion in a new perspective and thus makes a contribution to the literature on financial advisors and individual investors.

The dataset we use for this research stems from the private banking department of a large bank in Switzerland with mainly international clients. This unique data encompasses 4870 clients for the years 2005 and 2006. A client could choose between two different mandates: an advisory (non-discretionary) mandate or a discretionary mandate. With the advisory mandate, the client himself determines, which investment to make at what time. The bank consults the client with regard to an appropriate investment and carries out the relevant transactions. With the discretionary mandate, the investment of the client is mainly taken care of by the bank. The client and the bank make an agreement on the investment policy, which is implemented as precisely as possible afterwards. Therefore, the advisory mandate can be considered as an individual investment in an advisory context, while the discretionary mandate is an institutional investment. For both of the mandates, the clients have to pay fees periodically, where the fee for the discretionary mandate is higher than that for the advisory mandate. A distinguishing feature of our data is that it contains both types of clients. Each client in our dataset is marked as either having an advisory mandate or a discretionary mandate.

The goal of our study is to compare the performance of these two groups. To do so, the most natural question needs to be answered first: does the bank do a better job than the individual investors themselves? To assess the performance of the bank (the discretionary mandate clients) and the advisory mandate clients, the annualized return, the annualized volatility, the Sharpe ratio, the beta coefficient, Jensen's alpha and the Treynor/Black ratio are calculated from the data, taking into account the fees paid by clients. In the advisory mandate group, we additionally allow for heterogeneous investors. Some of them might have "strange" portfolios, e.g. because they use their bank account for hedging of other (unknown) positions or because they invest in a rather hazardous way: they might be either overconfident, under-diversified or easy to be influenced by attention and news, etc. As such accounts will inevitably worsen the average performance of the advisory mandate group, we have been looking for a method to exclude them from the analysis. To this end, we employ the mixture model and a cluster analysis to identify potential subgroups among the advisory mandate clients. The mixture model is a tool for examining and representing the presence of subgroups of individuals within an overall population, without requiring that an observable variable should identify the subgroup to which an individual observation belongs. Our algorithm is done in R with the package `mixtools`, see Benaglia et al. (2009).

We draw two main conclusions from the empirical results. First, there is a substantial group of advised individual investors that outperforms the bank-managed portfolios, at least after fees. Second, neither the better advisory portfolio nor the discretionary portfolio can beat the market. An index portfolio performs the best in our sample.

The rest of the paper is organized as follows. Section 2 discusses the performance difference between the two mandate groups and the difference among subgroups of the advisory mandate. Section 3 compares the performance of advisory and discretionary portfolios with a simple two-fund strategy. Section 4 concludes.

2. Does the bank do a better job than individual investors on their own?

2.1. Advisory mandate vs. discretionary mandate

Advisory mandate and discretionary mandate are two different services of private banking for investors. The advisory mandate allows the clients to make all their own investment decisions, whilst they have the access to the bank's research advice and execution services. The discretionary mandate authorizes the bank to manage a client's investment based on his investment objectives. Clients can remain involved and will receive reporting regarding the positioning and performance of their investment portfolio. The decision-making responsibility will lie with the bank.

The advantage of a discretionary mandate is a saving of time by relying completely on the expertise of the bank. With the expertise of the bank, clients can use the time saved to pursue their other commitments. The advantages of an advisory mandate are flexibility and autonomy. Some clients may want contribute more to the investment process than others, and are willing to make