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MODEL PORTFOLIOS

Simplify, Scale, and Succeed with Model Portfolios

By Michael Stillitano, CFA®, Ted Dimig, and Sharika Cabrera, CIMA®

INVESTMENTS & WEALTH INSTITUTE®

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Without question, model portfolios have taken the retail investment industry by storm. In fact, U.S. financial consultants—both broker-dealers (B/Ds) and registered investment advisors (RIAs)—have increased assets in fee-based models dramatically, from $2.6 trillion in 2008 to $9 trillion in 2018 (an increase of nearly 250 percent). By comparison, asset growth in commission-based brokerage was much more muted, beginning with $7.5 trillion in 2008 and growing to roughly $11.2 trillion in 2018 (an increase of less than 50 percent).[1] And there's no sign that this trend is losing steam: Research by Broadridge Financial predicts that model portfolio assets will more than double by 2023.[2] Many factors help explain this paradigm shift to fee-based models, but before we dive into those, what exactly is a model portfolio?

WHAT IS A MODEL PORTFOLIO?

In essence, a model portfolio is a fee-based investment solution designed for financial consultants looking to outsource portfolio construction responsibilities. Models typically come in a risk-based format, with risk profiles ranging anywhere from all fixed income to all equity, depending on the clients' suitability and overall risk tolerance. The first models incepted in the early 1990s and grew in popularity through mutual fund wrap sponsors and turnkey asset management programs (TAMPs). We can corroborate this based on our own experience in the models space. Our firm launched its first suite of model portfolios in July 2008, during the throes of the Global Financial Crisis, for one of the largest TAMPs in the United States.

Fast-forward to today, and the evolution of model portfolios as a service, with their own distinct ecosystem, has become apparent. Table 1 illustrates this point by breaking up the model portfolio landscape into four dimensions: model originator, distributor, economics, and discretion. To provide a real-life example, our firm clearly falls into the "model originator" bucket as an asset manager: Our Multi-Asset Solutions team provides asset allocation and manager selection recommendations to financial intermediaries, namely TAMPs, B/Ds, and RIAs, whose investment teams execute trades based on our investment guidance on behalf of financial consultants.

Distribution efforts come in many forms, but from our vantage point, distribution works symbiotically as a partnership between the asset manager and the financial intermediary. For example, the TAMP that we partnered with in 2008 hosts events for financial consultants, which we participate in to position our models. The most successful partnerships are those where the financial intermediary provides asset managers with the access needed to educate financial consultants.

The economics for model portfolios vary depending on the type of model and the economics of the financial intermediary, but the all-in fee usually comprises three components: (1) the underlying expense ratio of the vehicles in the model charged by the model originator, (2) the platform fee charged by the intermediary to the financial consultant, and (3) the advisory fee charged by

Table 1

DISTINCTIVE CHARACTERISTICS OF ASSET ALLOCATION MODELS, 2018

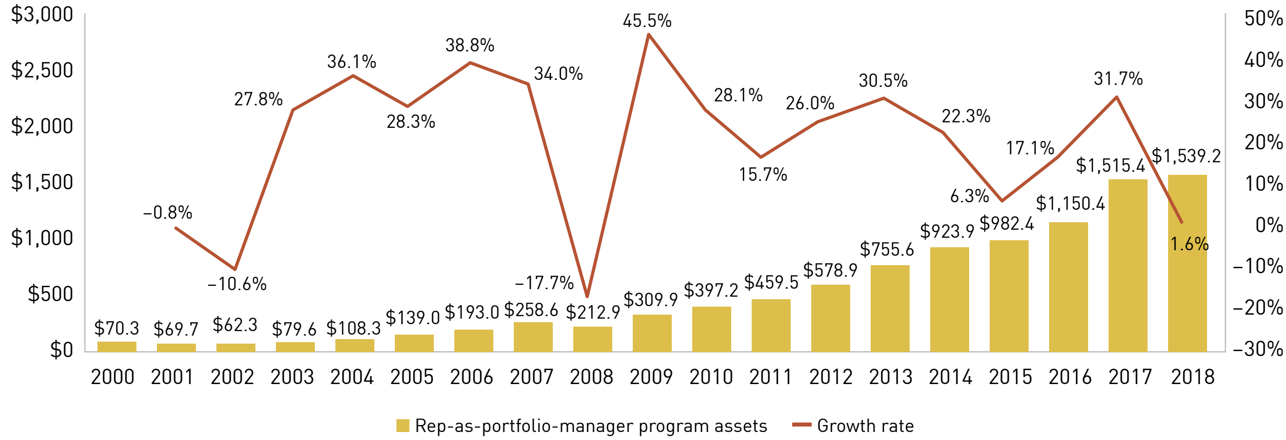
Models can be distinguished by model originator, distribution method, revenue model, and discretion.

Model Originator	Distributor	Economics	Discretion
Broker-Dealer	Broker-Dealer	Explicit fees	Model Provider
Asset Manager	Custodian	Underlying product	Broker-Dealer
Third-Party Strategist or TAMP	Managed Account Technology Providers	Advisor awareness	Advisor
Advisor	Fintech Marketplaces		Shared
	Paper Models		

Source: Cerulli Associates, December 2018. Shown for illustrative purposes only.

Figure 1

REP-AS-PORTFOLIO-MANAGER PROGRAM ASSETS, 2000–2018 ($ BILLIONS)



Analyst note: Capital market assumptions based on JPMorgan Asset Management's projections

Source: Cerulli Associates, J.P. Morgan Asset Management. December 2018. Shown for illustrative purposes only.

the financial consultant to the client, which is highly variable. Importantly, each of the aforementioned costs associated with model portfolios is fee-based, not commission-based.

Last, but certainly not least, is discretion. Who has discretion when it comes to model portfolios? The answer is that it depends. Figure 1 shows that rep-as-portfolio-manager (RPM) program assets skyrocketed from 2000 to 2018. These models can be classified as discretionary because the financial consultant directly owns the investment decisions and the trade executions. However, if we focus in on the red line in figure 1, the trend for RPM asset growth came down markedly from its 2009 peak of roughly 46 percent year-over-year growth to approximately flat in 2018. This downward trend is likely due to home-office investment teams lobbying for financial consultants to outsource portfolio construction responsibilities, a theme discussed in greater detail below.

On the other hand, nondiscretionary models relinquish one key element applicable to discretionary models: trade execution. From the financial consultant's perspective, nondiscretionary models come in two flavors, both of which preclude the financial consultant from executing trades directly for clients. The first is home-office models, which were designed by home-office executives at various B/Ds and RIAs to ensure financial consultant-managed or RPM models do not underperform portfolios of a similar risk profile.[3] The push for centralizing investment decision-making is most notable in the wealth management (wirehouse) space: Wirehouse firms accounted for approximately 77 percent of RPM assets in 2004, declining to just shy of 62 percent in 2018.[4] In addition to home-office models, asset managers also offer nondiscretionary third-party models, which often sit alongside home-office models on the same investment platform. Unlike home-office models, third-party model originators maintain ownership of portfolio construction but do not have custody of client assets and therefore cannot execute trades. This can also be referred to as an advisory service, because the model originator designs the model's asset allocation and manager lineup, but instead of executing the trades directly it delivers the trades as recommendations to a financial intermediary, typically its home office. Home offices continue to hire third-party strategists with institutional-quality investment expertise to run models on their platforms to complement home-office models, reduce capacity constraints, and provide financial consultants with more optionality for clients.

CATALYSTS FOR GROWTH

Three investment industry trends are promoting the growth of asset allocation models. They are the changing regulatory landscape, the increased use of outsourcing, and client preferences, each of which is discussed below.

REGULATORY LANDSCAPE

Following the Global Financial Crisis of 2008–2009, the federal government's regulatory response was swift and profound. It wasn't until 2015, however, that the U.S. Department of Labor (DOL) first proposed its fiduciary rule, which rocked the investment management industry. In short, the DOL fiduciary rule would have rendered financial professionals who advise retirement account investors as fiduciaries under the Employee Retirement Income Security Act of 1974 (ERISA). ERISA generally requires fiduciaries to refrain from conflicts of interest such as making investment recommendations that would increase their compensation. The impact of this proposal alone prompted some of the largest financial institutions in the world to move client assets out of commission-based brokerage accounts and into fee-based accounts, such as model portfolios, to avoid these potential conflicts.

Although the proposal ultimately was invalidated by a federal court, it moved the bar for fiduciary responsibility by financial consultants to clients meaningfully higher. In 2019, the U.S. Securities and Exchange Commission finalized its Regulation Best Interest for B/Ds and released guidance on the standard of conduct for RIAs. According to the Investment Adviser Association, these regulations are "intended to raise the standard of conduct for broker–dealers, reaffirm the fiduciary duty under the Investment Advisers Act, and reduce investor confusion about the services offered by and standards applicable to financial professionals that serve retail investors."[5] Because models are fee-based, a model's sheer structure better aligns financial consultants' interests with those of clients, increasing the likelihood of regulatory compliance in the process.

OUTSOURCING FOR SCALABLE AND SUSTAINABLE GROWTH

Model portfolios offer financial consultants a compelling solution from a regulatory standpoint, and nondiscretionary models (i.e., third-party and home-office models) can improve their growth prospects materially. How? By saving time. Survey data from Cerulli Associates asserts that financial consultants who insource portfolio management responsibilities spend roughly 19 percent of their time on investment-related tasks and 54 percent on client-facing activities.

Comparatively, financial consultants who outsource portfolio management responsibilities—either to a third-party manager or to home-office models—spend just 10 percent of their time on investment-related tasks and close to 62 percent on client-facing activities.[6] Further, it's estimated that financial consultants who outsource to a third-party or home-office model spend roughly 3.6 hours more each week on client-facing activities, or 180 more hours per year; this translates into an incremental 120 face-to-face client meetings annually (see figure 2).[7] This solution is particularly attractive for up-and-coming financial consultants looking to grow their practices in a scalable manner, or for more-established financial consultants looking to service smaller accounts without detracting value from larger accounts with greater complexities. Outsourcing allows financial consultants to scale their businesses, and it also makes succession planning more seamless: Clients can take comfort in the fact that an institutional investor, such as a third-party investment manager or a home-office chief investment officer, retains ownership of investment-making decisions and will continue to do so even after a financial consultant retires.

The recent spike in market volatility strengthens the case for outsourcing to a third-party model. According to Bloomberg, March 2020 was the most volatile month on record for the S&P 500 Index, with an average daily move of ±4.8 percent; the next closest months were in 1929, 1932, 1987, and 2008, all of which were below ±4 percent. It's times like these when financial consultants need to be fully accessible to clients, and managing portfolios during periods of extreme volatility can get in the way of the financial consultant's primary responsibility: easing clients' concerns and ensuring that they are on track to meet long-term financial goals.

Outsourcing to a third-party manager allows the financial consultant to be there when clients need them the most and allows a trusted investment manager to carry the load of asset allocation and manager selection.

CLIENT PREFERENCE

Models provide a wide array of benefits to financial consultants, and clients also benefit by being invested in a model portfolio. As mentioned above, financial consultants who invest client assets in a fee-based model portfolio are better aligning their interests with those of the client, because as assets grow, the client's net worth grows, and the financial consultant's dollar-fee grows in concert. It also could be for this reason that clients overwhelmingly prefer fee-based accounts to brokerage. A study by PriceMetrix found that 87 percent of clients prefer being invested in fee-based accounts as opposed to commission-based brokerage accounts (see figure 3).[8] Despite the clear preference for fee-based accounts, just 47 percent of client assets sit in

Figure 2

SPEND LESS TIME ON INVESTMENTS AND MORE TIME GROWING YOUR BUSINESS

Fewer investments to research and track + Less portfolio building, trading, and rebalancing + Simpler performance tracking and account reviews = Totals **180** more hours each year

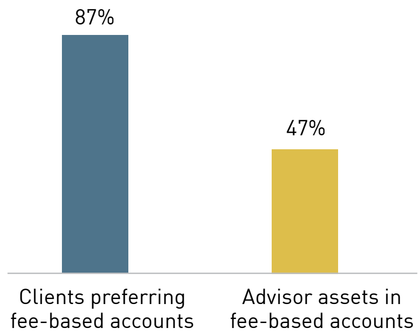
Model users spend ~3.6 more hours each week on activities that add value for clients, like estate planning, tax management, retirement planning, and providing peace of mind.

Source: Cerulli Associates, U.S. Asset Allocation Model Portfolios 2018. Illustration assumes a 45-hour work week, 50 work weeks per year, and 1.5 hours per meeting. Shown for illustrative purposes only.

Figure 3

BUILD A STRONGER PRACTICE WITH FEE-BASED ASSETS

Investors overwhelmingly favor fee-based accounts over brokerage



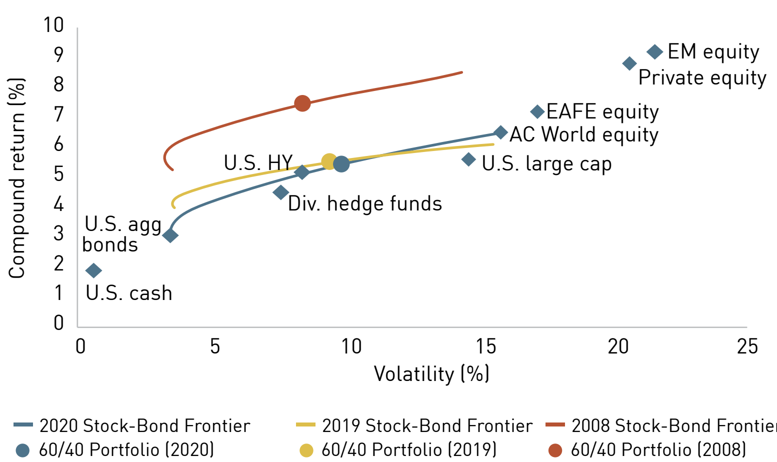
Fee-based assets
- tend to be more predictable than commissions
- better align your interests with clients
- reinforce your value as an advisor
- enhance client and asset retention

** Cerulli Associates, February 2019. Based on advisor-directed clients.*

*** PriceMetrix, 2018 data. Shown for illustrative purposes only.*

Figure 4

STOCK-BOND FRONTIERS: 2020 VS. 2019 AND 2008 ASSUMPTIONS (USD)



J.P. Morgan Asset Management. For illustrative purposes only. Expected risk and returns are based on J.P. Morgan's 2020, 2019, and 2008 Long- term Capital Market Return Assumptions (LTCMRA). 60/40 portfolio compositions: 60 percent All Country World Equity, 40 percent US Aggregate Bonds. Efficient frontiers based on portfolio combinations of Developed World Equity, Emerging Markets Equity, and US Aggregate Bonds. EM = Emerging Markets, DM = Developed Markets.

fee-based accounts today, underscoring the sizable growth opportunity for model portfolios.[9] Further, by reducing time spent on investment-related activities, financial consultants can deepen relationships with clients by allocating time to services that clients value more than investment management, such as financial planning, wealth management, and retirement solutions.[10]

KEY CONSIDERATIONS FOR FINANCIAL CONSULTANTS

To successfully utilize model portfolios in their practices, financial consultants need to heed three key considerations. They need to know each client's objectives and find a model provider with a proven track record and a value proposition that goes beyond investment management. These considerations are discussed below.

KNOW YOUR CLIENT'S OBJECTIVES

Model portfolios come in many different flavors given the wide array of client objectives, and a variety of models can help financial consultants address client goals. Some examples are the following:

- Traditional asset allocation models for clients looking to achieve a long-term risk/return profile commensurate with their risk tolerance
- Income-oriented models for clients at or near retirement and in need of a stable, consistent income stream
- Absolute-return models to help damp portfolio volatility and deliver modest returns above cash with a low correlation to traditional asset classes

Taking this a step further, models can be all active, all passive, or some combination of the two. With this in mind, having knowledge of a client's goals and objectives is paramount in order to choose the right model. But the most important portfolio construction decision remains in the hands of the financial consultant: the client's risk profile. Based on proprietary research, we found that returns and risk for a 60-percent equity/40-percent fixed income benchmark (60/40) drove roughly 80 percent of the return and 90 percent of the risk for our longest-standing model.[11] We proved our ability to add net-of-fee value—or alpha—over that benchmark, but picking the right risk profile has meaningful return and drawdown implications for clients, making it a critical decision.

TRADITIONAL 60/40 DOESN'T CUT IT TODAY

Finding a model portfolio is easy, but finding a manager that seeks to consistently provide investors with returns above a traditional 60/40 benchmark is much more difficult. According to our 2020 long-term capital market assumptions (LTCMAs), the expected return for a globally diversified 60/40 is roughly 5.4 percent annualized over the next 10–15 years. Comparatively, in 2008 our LTCMAs expected an annualized return closer to 7.5 percent with less risk for the same 60/40.[12]

This gulf in performance expectations underscores the return challenge that every multi-asset investor faces today.

However, we believe that this challenge can be overcome by finding a model provider with the expertise to pull on multiple levers to help bridge that return gap:

Diversified strategic asset allocation. Similar to picking the right risk profile, a client's strategic asset allocation is a critical driver of long-term results. Creating a well-diversified strategic asset allocation commensurate with the client's desired risk-return target can provide a better investment outcome over the long run (see figure 4).

Flexible asset allocation. Investors can stay reasonably within their risk profiles and be able to introduce dynamic asset allocation to an existing allocation to add or remove asset classes from their portfolios. Investors should be willing to introduce tactical asset allocation to capture market dislocations within equities, fixed income, and alternative asset classes. Asset allocation flexibility can improve total and risk-adjusted return, and it also can help manage downside risk and total portfolio volatility through asset allocation choices.

Manager due diligence. If index performance is going to be challenging, manager due diligence is a crucial component to finding ways to outperform the index. That's why it's so important to have a dedicated manager research team that looks for long-tenured managers with proven track records over multiple business cycles and environments.

THERE'S MORE TO MODELS THAN INVESTMENTS

Picking a model provider with a proven track record of strong performance is essential, but financial consultants also should think about a model provider's value proposition beyond investment management expertise. Content is one example: Financial consultants should expect managers to provide collateral that clearly and simply articulates the model provider's investment process, market outlook, current positioning, and performance. Easy-to-access content facilitates a more straightforward, simpler dialogue about investments between financial consultants and their clients, which can strengthen client relationships and build goodwill.

In addition to content, technology has become much more integrated in the retail investment space to make financial consultants' lives easier. Technology comes in the form of practice management solutions, portfolio analytics, tax management capabilities, and more. Each of these items can augment an advisor's practice.

FORWARD-LOOKING THOUGHTS AND VALUE PROPOSITION

Based on our experience as model providers, coupled with industry research, it is likely that the ascent of model portfolios will continue. Although models started off as an investment solution for resource-constrained independent B/Ds, we expect the RIA and wirehouse channels to begin adopting models more broadly as well—a trend we already are starting to see play out in our own book of business. Models also will continue to evolve into more customized solutions; separately managed account models, thematic models, open architecture, advanced tax management capabilities, etc., are topics that we believe will grow in popularity as model providers utilize technology to scale.

Importantly, outsourcing to a third-party model allows for a powerful yet straightforward value proposition for financial consultants. First and foremost, outsourcing provides financial consultants with the scale to increase client interaction and decrease time spent on arduous investment-related tasks. The fee-based structure of a model also can increase the likelihood of regulatory compliance, especially when compared to commission-based brokerage accounts. Finally, models can deliver an institutional-quality investment experience to financial consultants who may not have the portfolio management expertise or the resources needed to efficiently generate consistent outcomes for clients. Ultimately, this translates into a better investment experience for clients and an increased probability of keeping them invested, even in more challenging market environments.

For financial consultants who want to stay in vogue, model portfolios can help keep a practice trending in the right direction.

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SIMPLIFY, SCALE, AND SUCCEED . . .

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